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Global imbalances and monetary policy

Lorenzo Bini Smaghi [*,1]

European Central Bank, Kaiserstrasse 29, 60311 Frankfurt am Main, Germany

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Abstract

In the article I discuss some possible explanations for two features of financial globalization over recent years; first, the fact that expected returns have fallen significantly in advanced countries, even though economic growth has accelerated; and second, the fact that capital is flowing from poor to rich countries rather than the other way round, a phenomenon known in the literature as the "Lucas Paradox". The "incomplete" nature of globalization, notably the persistent differences in institutional quality between North and South, might explain *both* puzzles as well as the emergence of global imbalances. Alternative explanations based on a fall in risk premia and accommodative monetary policy conditions fit the facts less well. I then discuss the implications for monetary policy.
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1. Introduction

The effects of globalization on the conduct of monetary policy, especially in advanced economies, lie at the heart of many recent academic and policy debates. One difficulty in dealing with this issue is that we do not yet have a general equilibrium model that takes into account all relevant interaction between the various forces unleashed by globalization. As a consequence, the effects of globalization tend to be examined in isolation, from a partial equilibrium perspective, and this may lead to inappropriate conclusions.

I will focus in this article on the question of whether the fall in real long-term interest rates experienced in advanced economies over the last few years reflects a change in the global savings-

* Tel.: +49 69 1344 7170; fax: +49 69 1344 7163.
E-mail address: Lorenzo.binismaghi@ecb.int.
[1] Member of the Executive Board, European Central Bank.

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investment equilibrium, which should in theory be accommodated by monetary policy, or an excess of global liquidity generated by expansionary monetary policies, which should instead induce corrective monetary action. I will try to assess the way in which globalization affects monetary policy, even in a large economy such as the euro area. Since I do not possess a general equilibrium model capable of illustrating all the relevant interactions, I will use the available – yet imperfect – tools of partial equilibrium and try to combine the results of the partial analyses to improve our global understanding of the issue. One should not be disappointed by the fact that the results of such an analysis are not clear-cut. Economists and policy-makers are used to that. What is more important, especially for policy-makers, is to be aware of the risks of taking policy decisions in an uncertain environment, i.e. an environment of which they have only a partial understanding.

This paper is organized as follows. In Section 2, I describe two apparent puzzles in current international financial markets: first, the fact that long-term expected returns have fallen, particularly in advanced countries, while global economic growth has strengthened; and second, the fact that capital tends to flow uphill, i.e. from poor to rich countries, contrary to theoretical predictions (a phenomenon known as the "Lucas Paradox"). In Section 3, I will argue that an explanation centered around the existence of an institutional, legal and financial frictions, which make globalization "incomplete", can explain both paradoxes. In Section 4, I discuss the evidence on the incomplete nature of globalization, while in Section 5 I deal with some other possible shocks which may have affected global real long-term interest rates in recent years. Of particular relevance is the accumulation of excess liquidity made possible by accommodative monetary policy conditions worldwide. Section 6 discusses some monetary policy implications, and Section 7 concludes.

2. Financial globalization: twin puzzles?

Conceptually, globalization may be represented as a fall in trading costs between the rich North and the poorer South, using terminology proposed a few years ago by Krugman and Venables (1995). Globalization is expected to promote the convergence of asset returns across countries as a result of increased capital mobility and price equalization. There is indeed evidence that global factors matter more than in the past in determining long-term interest rates. Fig. 1 shows real long-term (10-year maturity) government bond yields for the United States (from 1980), the euro area (from 1987) and the average of advanced countries (based on IMF calculations; only available from 1992). The deflation of the nominal yields is effected by subtracting a measure of long-term inflation expectations. The evidence suggests two main developments. First, there is increasing convergence between US and euro area data, which is especially visible over the most recent period (see also Reichlin, 2006). Second, there is a clear downward trend in the series from the mid-1980s onwards.

The downward trend observed for real long-term yields in advanced countries is all the more striking given the apparent *rise* in the potential growth of the global economy, arguably unleashed by globalization.[2] Fig. 2 shows US real long-term bond yields alongside global annual real GDP growth. It is fairly evident that while the first series is on a downward trend, the latter moves upwards. This is the first puzzle: real long-term interest rates in advanced countries appear to have de-coupled from global economic growth. Such de-coupling represents a puzzle in a neoclassical model where potential output growth and the equilibrium level of the real interest rate are closely

[2] This hypothesis appears to be confirmed by the observation that it is developing countries, in particular export-oriented economies in eastern Asia, that have contributed the most to the increase observed in global real GDP growth.

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