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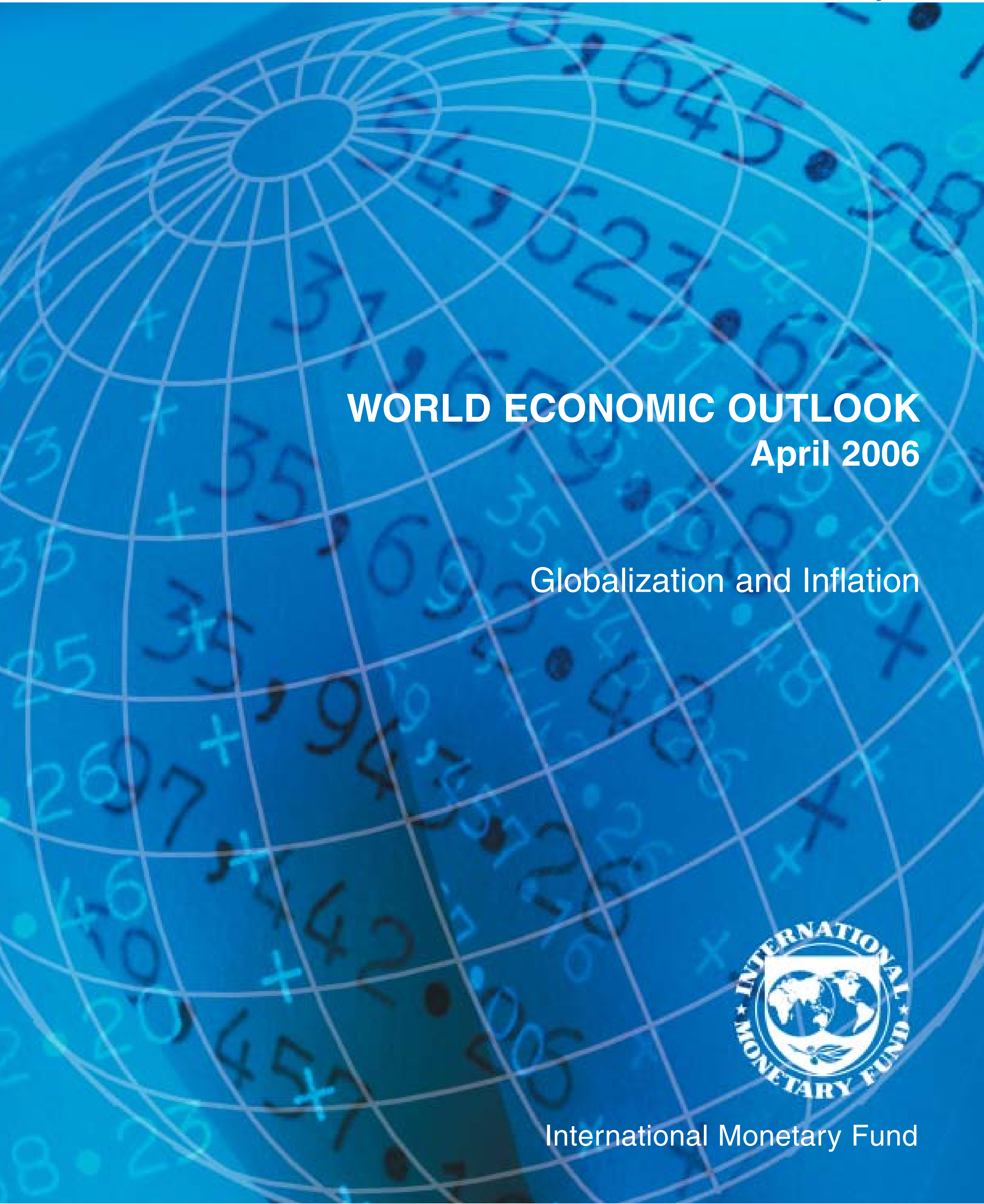

# WORLD ECONOMIC OUTLOOK

## April 2006

## Globalization and Inflation

International Monetary Fund

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# ASSUMPTIONS AND CONVENTIONS

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during February 9–March 9, 2006, except for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to remain constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box A1); that the average price of oil will be $61.25 a barrel in 2006 and $63.00 a barrel in 2007, and remain unchanged in real terms over the medium term; that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 5.0 percent in 2006 and 5.1 percent in 2007; that the three-month euro deposits rate will average 3.0 percent in 2006 and 3.4 percent in 2007; and that the six-month Japanese yen deposit rate will yield an average of 0.3 percent in 2006 and of 0.9 percent in 2007. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available through early April 2006.

The following conventions have been used throughout the *World Economic Outlook:*

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or negligible;

– between years or months (for example, 2004–05 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 2004/05) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percent point).

In figures and tables, shaded areas indicate IMF staff projections.

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

As used in this report, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

# FURTHER INFORMATION AND DATA

This report on the *World Economic Outlook* is available in full on the IMF's Internet site, www.imf.org. Accompanying it on the website is a larger compilation of data from the WEO database than in the report itself, consisting of files containing the series most frequently requested by readers. These files may be downloaded for use in a variety of software packages.

Inquiries about the content of the *World Economic Outlook* and the WEO database should be sent by mail, electronic mail, or telefax (telephone inquiries cannot be accepted) to:

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# PREFACE

The analysis and projections contained in the *World Economic Outlook* are integral elements of the IMF's surveillance of economic developments and policies in its member countries, of developments in international financial markets, and of the global economic system. The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department, the International Capital Markets Department, the Monetary and Financial Systems Department, and the Fiscal Affairs Department.

The analysis in this report has been coordinated in the Research Department under the general direction of Raghuram Rajan, Economic Counsellor and Director of Research. The project has been directed by David Robinson, Deputy Director of the Research Department, together with Tim Callen, Division Chief, Research Department.

The primary contributors to this report are Thomas Helbling, Subir Lall, Kalpana Kochhar, Sandy Mackenzie, Gian Maria Milesi-Ferretti, S. Hossein Samiei, Roberto Cardarelli, To-Nhu Dao, Selim Elekdag, Toh Kuan, Florence Jaumotte, Valerie Mercer-Blackman, Paul Nicholson, Alessandro Rebucci, Martin Sommer, Nikola Spatafora, and Johannes Wiegand. Christian de Guzman, Stephanie Denis, Angela Espiritu, Bennett Sutton, and Ercument Tulun provided research assistance. Mahnaz Hemmati, Laurent Meister, and Casper Meyer managed the database and the computer systems. Sylvia Brescia, Celia Burns, and Seetha Milton were responsible for word processing. Other contributors include Laurence Ball, Nicoletta Batini, Pelin Berkmen, Michael Bordo, James Boughton, Luis Catão, Jean Pierre Chauffour, Li Cui, Daniel Hardy, Lutz Kilian, Laura Kodres, Kornélia Krajnyák, Suchitra Kumarapathy, Doug Laxton, Vojislav Maksimovic, Sam Ouliaris, Lars Pedersen, M. Hashem Pesaran, Miguel Segoviano, Marco Terrones, Kenichi Ueda, and Frank Warnock. Jeff Hayden of the External Relations Department edited the manuscript and coordinated the production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the report on March 29 and 31, 2006. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

# FOREWORD

The *World Economic Outlook* is a cooperative effort. A few members of the Research Department put it together, but in doing so they rely heavily on staff from around the Fund. I thank Tim Callen, members of the World Economic Studies Division, and all the IMF staff from other divisions and departments who worked together to bring this *World Economic Outlook* to you. I am especially grateful to David Robinson, who has supervised an impressive series of high-quality *Outlooks* over the last six years, and will now be moving on to a different position in the Fund.

The world economy is in the midst of an extraordinary purple patch, with what looks like a third year of significantly above-trend growth. Growth is also becoming more balanced with Japan picking up strongly, and the euro area showing advance signs of steadier growth. Perhaps the best reflection of the times is that sub-Saharan Africa is headed for its best growth performance in over 30 years.

As past *Outlooks* have documented, an important reason for this good performance has been greater flows of goods, services, and capital across the world, a phenomenon known colloquially as globalization. The chapters in this *Outlook* all try to make sense of this phenomenon.

Chapter III, "How Has Globalization Affected Inflation?," finds that globalization has at times had an important impact on inflation over the past decade. IMF staff estimates suggest that through non-oil import prices, globalization has reduced inflation by an average of a ¼ of a percentage point a year in the advanced economies, with a larger effect of a ½ percentage point a year in the United States. At times when global spare capacity has been plentiful, as for instance after the 1997–98 crises in emerging markets, these direct effects have been even larger, shaving more than 1 percentage point off actual inflation in some advanced economies over one- to two-year periods. More generally, globalization has contributed to reducing the sensitivity of inflation to domestic capacity constraints, while increasing the sensitivity to global constraints. It has also restrained wage increases in industries most open to global competition, and even lowered the sensitivity of wages to productivity increases.

For globalization to have a substantial lasting impact on inflation, however, it must change the overarching objectives of monetary policy—such as the central bank's inflation target—which, over the medium term, determines inflation. After all, with such a target, downward pressure from abroad on the domestic price index would only allow central bankers more room to be accommodative. In my view, however, the true impact of globalization has been in contributing to wage and price restraint at a time when central bankers were establishing their inflation-fighting credibility, thus allowing them to achieve targets and gain credibility without the need to tighten to politically difficult levels.

Despite being helpful in the past, globalization may not continue to be a crutch for central bankers. Spare capacity is decreasing worldwide, especially in the United States, the United Kingdom, and Canada. International competition helps less in restraining prices when there are global supply constraints. Tight domestic labor markets can also attenuate the effects of global competition on wages—in the United States, wage pressures are beginning to come to the fore. Central bankers must therefore remain vigilant for signs of a pickup in inflation in the period ahead.

Another aspect of globalization is an integrated market for world savings and borrowing. What is particularly interesting here is that the identity of the savers and borrowers has shifted in the last few years. Corporations are usually net borrowers. In 2003 and 2004, though, total corporate excess savings (undistributed profit less capital expenditure) in the G-7 countries amounted to $1.3 trillion, which was more than twice the combined current account surpluses of emerging market and developing countries over the same period.

This increase in corporate savings can be decomposed into two main components. First, there has been a substantial increase in corporate profits in the G-7 since about 2000. In general, this has *not* been because of better operating profits, but because taxes and interest rates have come down so that profits after interest and taxes have gone up—in other words, profitability is largely due to accommodative monetary and fiscal policy rather than, as commonly believed, productive efficiency. The second and arguably more important component is falling capital spending. It accounted for as much as three-quarters of the total increase in corporate excess savings since 2000. One reason for lower capital spending is that the real price of capital goods has declined sharply, so less has to be invested to increase the real capital stock by a given amount. Another reason is a drop in *real* capital spending. Here there is no uniform pattern across all seven countries—the United States and Germany are responsible for much of the decline.

Taken together, Chapters III and IV suggest an extraordinary confluence of global forces have kept the world economy going in the last few years. As investment slowed following the overcapacity built up by excess investment in the late 1990s and early 2000s, excess corporate savings contributed to the global savings pool to push down long-term interest rates. Consumption picked up—driven more by accommodative policy and its effects on house prices and household wealth than by improved job prospects. Quiescent inflation, partly because of a significant global output gap, allowed monetary policy to be very accommodative. Now as the global output gap narrows, monetary accommodation is being withdrawn. Also real corporate investment is likely to pick up. Both will tend to reduce corporate excess savings and push up long-term interest rates. This will slow asset price growth, but consumption may continue to be supported, this time by improved job prospects.

Such a scenario would be the proverbial soft landing. There are less benign possibilities. For instance, consumption growth may fall more rapidly than anticipated as the froth comes out of house prices, and this may have knock-on effects on confidence and investment. Our overall assessment, taking a variety of risks into consideration, is that surrounding the central scenario of robust growth, the risks are weighted to the downside.

Even as the internal transition of savings from corporations to households and governments takes place within some countries, we also need a shift in aggregate demand across countries. Chapter II explains how the oil price shock—itself a result of past underinvestment in the industry—will widen existing global current account imbalances and prolong them. Because the inflationary consequences of oil prices have been limited—partly a result of globalization—and because financing conditions have been benign, oil consumers have not had to adjust as much as they did in the past. Oil producers are rightfully being more circumspect about spending, mindful of past waste. As a result, oil-price-induced imbalances are likely to be with us for some time.

Should this be a concern? More generally, should we worry about the size of the global current account imbalances, given that they have been financed so long? I think we should. For one, the benign global financing conditions appear to be turning so the past need not say much about the future. More important, the imbalances are unsustainable at their current level—even with increasing economic integration, there is a limit to how much a country can depend on the outside world. Deficit countries have to start thinking about weaning themselves of reliance on global savings while surplus countries have to find ways to depend less on external demand. Since adjustment is inevitable, would it not be better to commit to a medium-term policy framework today so that public policy can support private sector adjustment and ensure the process is smooth?

A set of such frameworks for all the major players would have two additional effects. First, it would indicate that the imbalances are a shared responsibility and help prevent concerns about imbalances degenerating into protectionism. Second, it would reassure financial markets that a policy framework for supporting adjustment is in place, thus limiting the risk of an abrupt and costly, market-induced, adjustment.

Unfortunately, the rapidity with which globalization is advancing seems to worry citizens. Some governments see their role increasingly as slowing globalization, extracting political mileage by pandering to vociferous interest groups obstructing change, rather than educating citizens to accept it. Even as linkages between economies grow, far too many governments are putting the slightest domestic constraint above any international interest. Others are reviving beggar-thy-neighbor policies, except they are now on the capital account—shielding large swathes of their own economy from corporate takeovers while encouraging their own companies to take advantage of the continued openness of others. Multilateralism is in retreat everywhere.

These are the best of times but they are also the most dangerous of times. We need to strengthen the process of multilateral dialogue, else globalization could prompt a backlash that might reverse much that has been gained over the last few decades. An important test of the resolve of economic policymakers is whether they will take serious steps to monitor each other (through organizations like the Fund) and force a narrowing of the imbalances over time, or whether they will take their chances with the market and protectionist politics. I hope good sense will prevail.

Raghuram Rajan
*Economic Counsellor and Director, Research Department*