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has to guard against any new risks arising out of any large corrections in the exchange rates of the world's major currencies accompanied by rising inflation and interest rates. First, the protectionist tendencies need to be curbed in keeping with the multilateral spirit of trade negotiations. Second, we need to work collectively toward developing a sound international financial architecture, the lack of which, it may be recalled, has led to excessive caution on the part of developing countries in building large reserves. Third, given the need for financial stability alongside monetary stability, central banks need to be cautious before joining the recent trend of separating the monetary and supervisory authorities, particularly in view of the muted responses to the pricing channels of monetary policy.

José Viñals

I will focus my comments on the challenges posed by globalization to central banks of advanced countries and emerging markets in their pursuit of both *price stability* and *financial stability.*

Starting with the facts, the recent wave of globalization we have experienced over the past ten to fifteen years has coincided with a very favorable macroeconomic performance. Inflation has come down and been kept low, global growth has been high, and financial markets have performed quite well. Consequently, prima facie there is nothing that should lead us into thinking that globalization has made the life of central bankers more difficult. If anything, one might suspect that it may have on the whole made it easier.

Nevertheless, we should delve further into the issue to ascertain whether this impression is in fact correct. In this regard, I think it is useful to take into account the impact of globalization through both the economic (e.g., trade, competition) and financial (e.g., capital flows) channels on both advanced economies and emerging markets.

As concerns the *economic channel,* the available evidence suggests that globalization has provided a favorable backdrop for the conduct of monetary policies aimed at achieving or maintaining price stability. In advanced economies globalization has led both to lower low-skilled manufacturing import prices and to higher commodity import prices. These two opposing forces have, on balance, exerted a modest disinflationary effect in advanced countries in recent years. Although it is clear that such changes in relative prices cannot lead to any permanent consequences for the rate of inflation over the medium term (as this is chosen by the central bank), they have reduced measured inflation on a temporary basis. Moreover, as such changes in relative prices have been over a prolonged period, the downward

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impact on the actual rate of inflation has also been prolonged, even if not permanent.

Interestingly, the consequences for emerging markets have been quite different, particularly in those economies that are net exporters of low-skilled manufactures and/or commodities. As is well known, in recent years many of these countries have run large trade surpluses and accumulated foreign reserves that have contributed to domestic monetary expansions and resulted in internal inflation pressures. However, in my opinion, this has not been so much because of globalization but because of the pegged exchange rate or managed floating policies pursued in many cases. Indeed, floating exchange rate policies would have avoided the foreign reserves accumulation processes that have been at the origin of inflation pressures.

The next question to ask is whether economic globalization has had more permanent effects on inflation by enhancing domestic wage and price discipline through intensified external competition and offshoring. Indeed, there is some evidence that suggests that estimated short-term Phillips curves are now flatter in a number of countries. While this evidence is not uncontroversial, it is nevertheless useful to think about what this would imply were it to be confirmed by subsequent analyses.

The answer, as we might suspect, very much depends on why there is such a flattening. Those who strongly believe that globalization is the main factor behind it will conclude that this allows for more relaxed monetary policies in the presence of a more favorable short-term trade-off. On the contrary, those who believe that it is not so much globalization but rather the anti-inflationary credibility of central banks that is responsible for the flattening of the curve through better anchoring of inflationary expectations, draw very different implications. Specifically, they point to the dangers of unwarrantedly relaxing monetary policies, as this would deanchor inflationary expectations and lead to an upward shift in the now flatter curve with the resulting increases in inflation. As you may imagine, being a central banker I tend to side with the second view and thus believe that preemptive monetary policy is as important as ever even if the short-term trade-off appears to be more favorable nowadays.

As concerns the impact of globalization through the *financial channel,* I think that the consequences for central banks are more important. On the one hand, the conduct of domestic monetary policy is becoming more complex insofar as long-term real interest rates are increasingly being determined at the global level and, particularly, because in recent years it has become more difficult to understand why long-term real interest rates are so low worldwide. In practice, this "conundrum" leaves central bankers with higher margins of uncertainty regarding the level of the "neutral" equilibrium real rate against which to gauge the stance of monetary policy.

On the other hand, financial globalization poses considerable challenges for central banks as concerns the preservation of financial stability. In recent years, financial globalization has led to a new global financial landscape as a result of several developments: (a) the trend toward bank disintermediation, exemplified by the surge of new players such as hedge funds, private equity firms, and special investment vehicles; (b) the appearance of new, increasingly complex and hard-to-value structured products; and (c) the rapid integration of national financial markets in a global environment of increasingly unconstrained capital flows.

While it is true that the new financial landscape contributes to the completion of financial markets and allows for a better dispersion of risks, it is also the case that an increasing part of the global financial system is operating through unregulated entities, where transparency is rather weak. As a result, it is now more difficult for the authorities in charge of financial stability to know how much risk there is in the financial system, who is ultimately bearing it, and whether there are pockets of vulnerability where risk is being concentrated.

Admittedly, the new financial system has shown significant resilience in recent years when faced with a number of adverse shocks (e.g., the bursting of the dot-com bubble, September 11, corporate scandals, downgrading of General Motors and Ford bonds, Amaranth fall), which points to the value of risk diversification. However, doubts exist about whether the new system will prove so resilient when faced by larger shocks in the future, in particular given the pockets of vulnerability to which I referred.

All of these uncertainties linked to financial globalization pose considerable challenges for central banks in preserving financial stability. Moreover, they can complicate the task of monetary policy in preserving price stability insofar as there is a need to know how the new financial landscape affects the monetary transmission mechanism. These complexities are likely to increase over time.

In spite of the aforementioned uncertainties and challenges, there is no doubt that financial globalization has been a very beneficial development for the global economy and not just for advanced economies. Indeed, emerging markets have also greatly benefited from the freedom of capital flows, which has provided external discipline on central banks and increased the penalties—in the form of sudden stops and capital flow reversals—for not following low inflation policies. Moreover, financial globalization has also helped financial stability in these economies by providing a favorable backdrop for the development of domestic capital markets. As is known, in emerging markets the development of bond markets in local currency allows for the dedollarization of the economy and makes the domestic financial system more resilient.

To conclude, the process of globalization does not seem to have diminished the ability of central banks to run monetary policies that effectively pursue price stability. Nevertheless, it has to be acknowledged that interactions within the global economy have to be increasingly taken into account when setting policy. Moreover, going forward it is the financial dimension of globalization that is likely to be most challenging for central banks, both for the conduct monetary policy and particularly for the maintenance of financial stability. This is where I feel that more research is needed.

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