Flattened Inflation-Output Tradeoff and Enhanced Anti-Inflation Policy as an Equilibrium Outcome of Globalization

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December 2007

Summary

One of the most notable developments of the past decade or so has been the apparent flattening of the short-run tradeoff between inflation and activity. The seventies were characterized by an almost vertical relationship in which the attempt to hold unemployment below its natural rate resulted in rising inflation. In the eighties, the downward sloping relationship reappears, as inflation was squeezed out of the system by the slack of the economy. However, since the early nineties, the relationship looks to have been rather flat. Three factors: – increased specialization; the intensification of product market competition; and the impact of that intensified competition and migration on the behavior of wages – should all work to flatten the short-run tradeoff between inflation and domestic activity. At the background, a massive globalization process has swept emerging markets in Latin America, the European transition economies, and the East Asia emerging economies in the past two decades. The 1992 single-market reform in Europe, and the formation of the Euro zone, are remarkable episodes of globalization. Similarly, emerging markets, including China and India, became significantly more open.

The paper provides a unified analysis of globalization effects on the Phillips curve and monetary policy, in a New-Keynesian framework. The main proposition of the paper is twofold. Labor, goods, and capital mobility flatten the tradeoff between inflation and activity. If policy makers are guided by the welfare criterion of the representative household, globalization forces also lead monetary policy to be more aggressive with regard to inflation fluctuations but, at the same time, more benign with respect to the output-gap fluctuations.

The paper assumes that the flex-price markup is constant, unaffected by globalization forces. If globalization reduces the markup, our model predicts that this effect, by itself, leads to a more forceful anti-inflation policy, and lessens the attention given by the policy maker to the fluctuations in economic activity.