

Globalization and Disinflation: The Efficiency Channel

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June 2005

Summary

Global inflation dropped from 30 percent a year to about 4 percent a year in the 1990s. At the same time, massive globalization process also swept emerging markets in Latin America, the European transition economies, and East Asian economies. Furthermore, the 1992 single market reform in Europe and the formation of the Euro zone are important episodes of globalization which took place in this period. Thus, globalization and disinflation seem to go hand in hand.

The paper analyzes how globalization forces induce monetary authorities, guided in their policies by the welfare criterion of a representative household, to put a greater emphasis on reducing the inflation rate than on narrowing the output gaps. We demonstrate that with capital account liberalization the representative household is able to smooth fluctuations in consumption, and thus becomes relatively insensitive to fluctuations in the output gap. With trade liberalization the economy tends to specialize in the production of relatively few varieties of goods. The expected disutility of labor supply diminishes, arising from fluctuations in surprise inflation as a result of the increase in the dispersion of the supply of the various varieties. Trade openness, characterized by the specialization in production of relatively few goods magnifies the negative effect of the price-quantity dispersion. Thus specialization in production as a result of trade openness increases the distortion associated with fluctuations in the inflation rate.

We provide evidence on the central bank preferences and trade and capital openness, which supports the theory prediction that goods and capital markets' openness increases the distortion associated with fluctuations in inflation and decreases the distortions associated with fluctuations in the output gap.

Summing up, when trade and financial openness increase, policymakers that are guided by efficiency considerations become more aggressive on inflation and less responsive to the output gap.