

Globalisation can be defined as the growing interdependence of national economies as reflected in the growth of international trade in goods and services, financial flows, and the movement of labour across borders.¹ The process of globalisation has accelerated over the last two decades as a result of economic and financial deregulation, political changes, advances in information technology and declining transaction costs. The effect on small open economies like Iceland may be particularly large. It has opened new export markets for Icelandic firms and the opportunity of expanding worldwide, but also brought greater competition to domestic product markets and tradable services. The opening of labour markets is of particular importance to volatile economies characterised by large fluctuations in investments.

By making the economies of the world more interdependent, globalisation may have increased cross-border spill-over effects on domestic monetary policy. There are two strains of the debate on the effects of globalisation on monetary policy. One concerns the impact of globalisation on inflation, the other the implication of *financial globalisation* for the transmission mechanism of monetary policy and hence the ability of central banks to contain inflation. It is the latter aspect of globalisation that, in recent years, has probably had the most significant impact on the Icelandic economy. Financially, globalisation has played a part in the build-up of an enormous deficit on the current account in Iceland and many other countries and surpluses in others. Cross-border assets and liabilities have also multiplied as a result of the removal of capital controls. One should make a distinction, however, between globalisation as a long-term process and the recent conditions of abundant global liquidity, which are at least partly due to effects of monetary policy, for example in the US and China, and hence likely to be temporary.

Globalisation and inflation dynamics

While one could easily argue on both theoretical and empirical grounds that globalisation has changed the transmission mechanism of monetary policy in Iceland in terms of being less effective and foreseeable in the long run, one should not jump to the conclusion that it is totally ineffective or without room for improvement. Domestic factors like the effect of liberalisation of Housing Finance Fund (HFF) lending rules and privatisation of the banks combined with cheap credit from abroad have contributed to intense competition in the mortgage market, leading to falling mortgage interest rates at a time when monetary policy was being tightened. This happened at a time when the economy was facing multiple demand shocks. Globalisation has contributed to some problems for monetary policy but has alleviated others. Domestic firms expanding abroad and foreign investments in Iceland have contributed to domestic labour shortages and fuelled excessive wage growth, but at the same time labour imports have alleviated wage pressure, though not enough to prevent a wage-inflation spiral.

Domestic financial market conditions

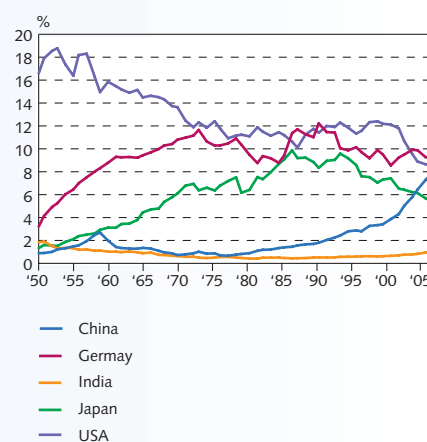
In the absence of currency risk, globalisation should in theory lead to the equalisation of long-term interest rates, but it does not fully do so due to exchange rate risk as well as other country specific risk factors. In fact, with a high degree of capital mobility, changes in the interest rate differential with abroad have a significant impact on the

Box III-1

Globalisation and monetary policy in Iceland

Chart 1

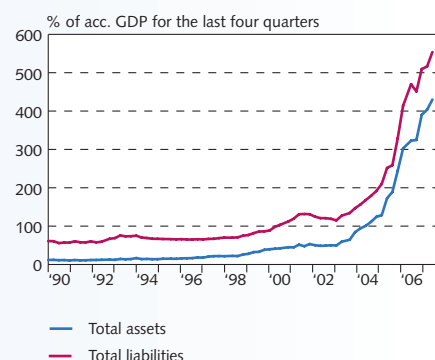
Trade globalisation 1950-2006
Share of world exports



Source: WTO.

Chart 2

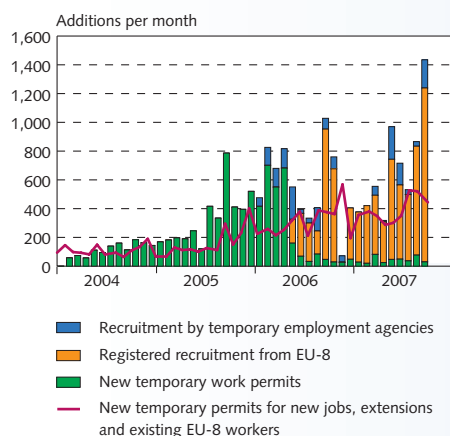
Financial globalisation
Iceland's foreign assets and liabilities. Q1/1990 - Q2/2007



Sources: Statistic Iceland, Central Bank of Iceland.

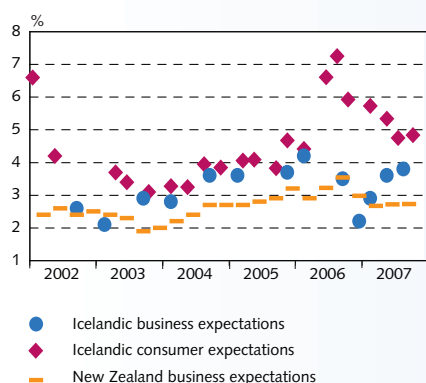
1. For further reading, see the speeches by Charles Bean (2006), "Globalisation and inflation." Ben S. Bernanke (2007), "Globalization and monetary policy," and Svein Gjedrem (2006), "Globalisation and monetary policy in Norway" as well as the papers by Kenneth S. Rogoff (2006), "Impact of globalization on monetary policy" and Michael Woodford (2007), "Globalisation and monetary control."

Chart 3
Labour globalisation
Foreign labour in Iceland



Source: Directorate of Labour.

Chart 4
Inflation expectations
in Iceland and New Zealand
Expectations according to surveys one year ahead



Sources: Central Bank of Iceland, Reserve Bank of New Zealand.

exchange rate (a rise usually leads to a currency appreciation). To some extent this may make monetary policy more effective. However, the link between interest differential and the exchange rate is not very predictable. Exchange rate behaviour may also be affected by non-observable factors such as variable risk aversion, which at times can lead to herd-like behaviour in financial markets. That makes forward-looking monetary policy in a small open economy with a high degree of pass-through a challenging endeavour. Further, a global savings glut - which has fuelled global liquidity - could have made monetary policy more challenging, with a diminished ability of the policy rate to influence domestic real interest rates, especially longer-term rates.²

If inflation expectations are not sufficiently anchored, the interest rate differential required to bring inflation expectations back in line with target may induce large capital flows and hence exchange rate instability. It stresses that communication of monetary policy and the management of expectations is more crucial than ever.³ In countries like New Zealand, which experience shocks of similar magnitude as Iceland, inflation has settled at low and stable levels, emphasising that achieving the target is possible as a result of high credibility of the monetary policy.

The conclusion is that globalisation has not interfered fundamentally with the ability of domestic monetary policy to control domestic inflation over the medium to long run, even in a small open economy like Iceland. However, it may have raised the cost of being seriously "out of sync" with the rest of the world by making the short term trade-off between inflation and output volatility less predictable. Although the interest rate channel of monetary policy may have been somewhat weakened as a result of abundant global liquidity, domestic obstacles that interfered with the pass-through of the policy rate into effective lending rates in the mortgage market have played an important role too. Before jumping to the conclusion that monetary policy has become totally ineffective as a result of globalisation, these imperfections should be addressed by policymakers.

- Long-term (real) interest rates are increasingly co-moving across countries, a phenomenon also evident in other asset classes like equities and housing. Researchers affiliated with the Bank of International Settlements (BIS) have also reported results favourable to domestic inflation becoming increasingly influenced by a global output gap, and thus possibly weakening the near-term efficacy of domestic monetary policy. See Claudio Borio and Andrew Filardo (2007). "Globalisation and inflation: New cross-country evidence on the global determinants of domestic inflation," BIS working papers no 227. There is no consensus on the robustness of these results, however.
- See Box III-2 on page 26 for an assessment of the effect of publishing the staff's projection of the policy rate path on the control of medium-term interest rates.