The Search for New Global Economic Order

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1. Introduction

The world is currently undergoing much of economic turbulence. Many countries in the world are suffering from a series of severe problems including global imbalances, global financial crises, global unemployment, and currency devaluation competition. These problems tend to sequentially and repeatedly occur in a vicious circle due to uncertainty, asymmetric information, external diseconomies, and policy failures. We are concerned that the severity of the current problems may even be intensified unless preventive measures are undertaken. In this paper we review the problems of external diseconomies and of asymmetric information in the interdependent world economy and propose the establishment of new global economic order which will hopefully cut the chain of the world's sequential problems.

2. Review of the Coase Theorem on Externalities

Ronald Coase, Professor of the Law School of the University of Chicago (1960) argued that if property rights are well defined and transactions cost is negligibly small, externalities may be internalized by market forces and he won the Nobel Prize in economics in 1991. In the annual meetings of the Mont Pelerin Society held in Sydney Australia in October 9-15, 2010, Harold Demsetz, Professor Emeritus of UCLA reexamined the work of Prof. Coase and criticized him for his errors.

The Mont Pelerin Society was founded in 1947 by Frederich von Hayek. Its foundation meeting was held at Mont Pelerin, near Montreux, Switzerland. Its objective was to facilitate an exchange of ideas between like-minded scholars in the hope of strengthening the principles and practice of a free society and to study the virtues and defects of market-oriented economic systems. Later many Nobel Laureates in Economics joined the Society including Milton Friedman, George Stigler, and Gary Becker. At present Prof. Becker is the senior leader representing the Society.

Professor Demsetz was critical of the Coase theorem because he believed Coase was overly obsessed with the prohibitively high transactions costs and tended to resort more to the government coercion rather than to market solution. Prof. Demsetz argues that transactions may not be high considering the entire externality costs the society or the world will have to pay. His argument provides new insights into the implication of transaction costs. We can extend our analysis of externality problem from the national boundary to the global boundary. We can get together to discuss and agree on some measures to prevent our common externality problem, to avoid our asymmetric information problem, and to avoid policy failure problem.

3. Intensifying Externality Problems in the Global Economy

Import liberalization can bring both benefits and costs. Under certainty and symmetric information, all countries can benefit from free trade. Under free and fair trade, an increase in income in one country brings benefit to the partner country as the former country imports more from the latter country. In the real world, however, information is not perfect. Thus import liberalization can magnify its adverse effects. In many cases, international trade is not fair. The world is full of uncertainties. Differences in religion and ideology impair free trade. Natural disasters that unexpectedly erupt in one country immediately affect the world economy. Political instability easily undermines the domestic as well as the global economy. Policy failures out of ignorance can drive the regional and global economy into crisis. Under mutual mistrust, countries resort to ‘Beggar thy neighbor’ policy which soon entails retaliation. So much of externality exists in today’s world. This externality problem intensifies along with the global trend of capital liberalization.

Capital liberalization can also bring benefits and costs. Due to the nature of capital, however, the effects of capital liberalization are much larger and quicker than those of import liberalization. Free capital mobility potentially contributes to increases in global economic efficiency. However, the short-term speculative capital transactions can lead to regional and global financial crises. Cross-border capital transactions entail currency exchanges. Consequently the short-term speculative capital flows make the exchange rates fluctuate wildly. International portfolio investors quickly move their funds to other countries when they see a sign of political crisis. When a global financial crisis occurs for one reason or another, countries with persistent trade deficits and large foreign debt will become the worst victims. The global externality problem will increase as the formerly socialist countries adopt the free-market system. Political instability, religious and ideological confrontation, asymmetric information in terms of adverse selection and moral hazard, and policy dilemma will all contribute to the intensification of the externality problem in the global economy. At present we do not have the global government nor do we have the global central bank. Under these circumstances, responsible countries may get together using the vehicle of the G20 process to discuss and agree on measures to eliminate or reduce the sources of the externality problem.

4. Controversy over Global Imbalances

The definition of 'global imbalances' is ambiguous. It refers to global imbalances in the trade account. It also refers to global imbalances in the capital account. There are two opposing views about the causes of global imbalances. One is the 'Beggar thy neighbor' policy view which states that global imbalances are the result of aggressive devaluation policy. The other is the excessive consumption view stating that global imbalances are the result of excessive use of energy by the entire world and excessive consumption by the US.

Whatever view one may hold on to, once a global imbalance is resulted, it generates a chain of adverse effects. The global imbalances that had previously prevailed induced China and OPEC nations to hold huge amounts of foreign reserves. This naturally led to the recycling of massive amounts of capital funds from the trade-surplus countries back to the US, which in turn, caused the bubbles in the prices of real estates, stocks, and bonds in the US. When these bubbles burst, the US ran into crisis and the 2008 global financial crisis was resulted.

5. The 2008 Financial Meltdown and Policy Dilemma

After the 1997 Asian crisis, people believed that a financial or currency crisis would tend to hit mostly the emerging or developing countries with persistent trade deficits. This belief, however, proved not to be true when the US, the world's most powerful economy ran into a financial crisis in the fall of 2008.

The US 2008 financial meltdown started in March 2008. Bear Stearns, the 5th largest investment bank had a run on its funding and was forced to sell itself to J.P. Morgan for less than 5% of what it was worth just a year earlier. It had invested heavily in subprime-related securities. The Fed had to take over $30 billion of Bear Stearns' hard-to-value assets. In July Fannie Mae and Freddie Mac, the two privately owned government-sponsored enterprises insured over $5 trillion of mortgage-backed assets. On September 15, Lehman Brothers, the 4th largest investment bank by asset size with over 600 billion and 25000 employees filed for bankruptcy. The day before, Merrill Lynch, the 3rd largest investment bank announced its sale to Bank of America for a price 60% below its price a year earlier. On September 16, AIG an insurance giant with assets over $1trillion suffered an extreme liquidity crisis when its credit rating was downgraded. The Fed decided to help out AIG with loans of $173 billion.

A serious question at this point arises, "How come the US, the most powerful economy on earth could not prevent its 2008 financial meltdown?" The US is the country that has the richest pool of the world's best minds and much talented people. They could have done something to avoid the disastrous crisis. An exemplary feedback from a handful of American economists is the following: There are about four reasons. First, the US home ownership policy was wrong because the US government tried to allow low-credit people to buy houses. Second, the Basel II regulation induced the commercial banks to supply collateral-based loans to the customers. Third, the price of crude oil doubled from $70 to $140 and the value of the household's income and wealth decreased drastically. Fourth, economists and policy makers tend to stay silent on an occasion that happens in "75" years. (On a very rare event) The bottom line of this feedback is that any country can become a victim when it meets unexpected shocks or when it experiences policy failures.

Policy failure occurs for a variety of reasons. A critical policy failure occurs when the individual country is caught in a policy dilemma. The conventional policy dilemma is the short-run trade-off between inflation and unemployment at the national level. For example, Korea has adopted inflation-targeting policy. In this situation, if it increases money supply to promote employment, it may not be able to achieve its inflation target. In addition, Korea is in a position to go for achievement of the global objective.

There is another policy dilemma at the global level. It refers to an objective dilemma between the national objective and the global objective. Until a little while ago after the 2008 global financial crisis, four major countries, China, Japan, Korea, and the US used to take an expansionary policy simultaneously in the hope that the regional and global economies will soon recover. For China, its global objective is to correct the global imbalances by reducing its ever-increasing trade deficits. For Japan, it also faces a dilemma between the global objective of recovering the world economy and the national objective of increasing its employment. For the US, it faces a critical dilemma between the global objective of maintaining the stability of the US dollar and the national objective of promoting export and employment. In this manner, all countries seem to be suffering from policy dilemma of one type or another.

6. New Global Economic Order

Under the conditions of asymmetric information, political instability, and global externality, global imbalances and devaluation competition would last for some time to come. Trade account imbalances yield capital account imbalances, which, in turn causes bubbles in the prices of real estate, stocks, and bonds. When the bubbles burst, the economy runs into a crisis. To cut off this chain of crisis events, both economists and political leaders will work together and agree on some effective measures. To reduce the problems of uncertainty and information asymmetry, range-targeting may be pursued for stability of export, output, and employment just as range-targeting has been pursued for stability of prices or low inflation.

Economic objectives may conflict with each other in the short run. However, they may be in harmony in the long run. For example, if range-targeting is pursued for price stability on a long-term basis, the central bank can focus on reducing output fluctuation by allowing inflation to deviate from the long-term target. Without perfect foresight, range-targeting is better than point-targeting for low inflation. The Bank of Korea has set the inflation target at a rate within a range of 2-3 percent.

In the same manner, range-targeting may be pursued for the long-term stability of trade balance and the target range for the ratio of trade balance to GDP may be set between 3-5 percent. This number is simply out of rule of thumb. The specific number for the target range for participating countries may be determined through discussions by specialists. If a proper target range is agreed upon among the major countries, region or global-wide devaluation competition may be stopped.

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