Creating a Harmonious Global Economic Order

The challenge facing policymakers is to adopt a rules-based approach, which means supporting property rights, free markets and long-term monetary rules

By James A. Dorn

February 17, 2015

International economic order depends on credible rules that discipline and limit government power while allowing the freedom to engage in mutually beneficial trades. In creating a harmonious global order, therefore, governments must first get their own houses in order.

In doing so, the first principle should be "Do no harm." This means policymakers should take account of the long-run consequences of their actions, rather than wedding themselves to the short run. They should also recognize that there is no perfect system. Every policy choice has costs and benefits; trade-offs are a fact of life. A principled approach to policy, however, will have positive spillovers as other countries follow suit.

When thinking about international balances and monetary stability, it is essential to recognize the fundamental problem of determining the proper balance between state and market – that is, between the use of force and freedom. If the force of law/ government is limited to the protection of persons and property, markets, i.e., voluntary exchange, can operate to create social and economic harmony.

The free trade movement of the 19th century and the classical gold standard are two notable examples of harmonious international order, but so are the rise of globalization since the 1970s and the emergence of China as the world's largest trading nation. By liberalizing the foreign trade sector and moving to market pricing and away from central planning, China has greatly increased its standard of living while benefiting its trading partners. However, progress has been uneven, and China still has a long way to go before it is ranked as highly as Hong Kong in terms of economic and personal freedom.

Commitment to rules is not easy. In practice, governments prefer discretion over rules and don't like to make hard choices, so they tend to favor managed exchange rates, activist central banks and capital controls.

In this mixed system, there is uncertainty about future policy and a lack of the discipline that would exist with known rules and a long-run commitment to a principled approach. Today's system of managed (pegged) exchange rates should not be confused with a true rules-based system under which monetary policy would be passive.

Temporarily pegging one's currency at an artificially low rate to stimulate exports is also not to be recommended. As other countries retaliate by devaluing their currencies, overall trade is adversely impacted – and rising mercantilism breeds ugly trade nationalism. Protectionism and capital controls also impede the international price system and erode confidence in the rule of law. Moreover, they create monetary uncertainty as central banks redirect policy toward maintaining politically determined exchange rates rather than adhering to a long-term rule.

The alternative of adopting a freely floating rate system to adjust to external imbalances while using a monetary rule to discipline an activist central bank is not appealing to most policymakers. Such a system would limit their discretion and diminish their importance.

The choice of policy rules will depend on many factors, but in making choices policymakers should remember the logic of the international price system and that a harmonious international system depends on harmony at home. If the United States, in particular, practices what it preaches – market liberalism – others are more apt to follow.

The monetary activism that has characterized major central banks since the 2008 financial crisis is not a panacea for real economic growth. Today's problems do not stem from a lack of money. Unless countries get the rules right, growth will remain sluggish. Devaluations and quantitative easing are not the answer.

Getting the rules right secures property rights, promotes economic freedom, and reduces government intervention. Lowering the costs of doing business and increasing the flexibility of prices (including factor prices) would expand the size and scope of markets. In contrast, increasing taxes and regulations on entrepreneurial activity, and attempting to manage trade, merely guarantees stagnation.

The European Central Bank's decision to engage in large-scale asset purchases, along the lines used by the Federal Reserve, the Bank of England and the Bank of Japan, may excite financial markets in the short run but will ultimately end in tears. Likewise, currency manipulation cannot guarantee prosperity, but leads to currency wars and a potential race to the bottom.

Central banks that undervalue their currencies jeopardize longer-run financial stability and growth. Meanwhile, as market forces change, significant pressures can build for revaluation. History is replete with such cases – the latest being Switzerland. It does not make sense for an economically free country like Switzerland to try to undervalue its currency to stimulate exports, and in so doing risk inflation or a revaluation that imposes losses on the Swiss National Bank's euro assets – and ultimately on taxpayers. The Swiss error was not to de-peg but to peg in the first place.

The challenge facing policymakers is to adopt a principled, rules-based approach to creating a harmonious global order. That means supporting private property rights, free markets and credible, long-term monetary rules.

James A. Dorn is vice president for monetary studies and a senior fellow at the Cato Institute in Washington