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A New, New World Order?

Challenges for International Economic Policy in the New Millennium

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March 2005

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A new, new world order?
Challenges for international economic policy in the new millennium[1]

Introduction: a new, new world order?

In the aftermath of the Iraq war, and following the re-election of US President George W Bush, the claim is sometimes advanced that we are living in a new, new world order, and that this poses new challenges and dilemmas for policymakers. Most often, this proposition is advanced within the context of supposed transformations in the international political and security environment. Can the same claim be made for the international economy? At a time of high and rising levels of international economic integration ('globalisation'), of the emergence of new Asian economic powers (China and India), and of growing strains on the current international economic architecture, the case for a new global *economic* order cannot be simply dismissed out of hand. At the same time, the international economic circumstances within which Australia is operating, in particular the regional environment, are also undergoing a process of restructuring. But are all these changes enough to warrant the claim of a completely new international economic system? And what do they entail for international economic policy?

New world order version 1.0

Before considering whether the current environment really is a *new*, new world order, it is helpful to review some of the previous occasions on which the term has either been explicitly deployed, or at least implicitly warranted.

Perhaps the first time that the term 'new world order' was thrown around in international policy discussions was in the period after the First World War, when it was used by US President Woodrow Wilson during the creation of the League of Nations and the associated efforts to build a new international regime of collective security.[2] This was new world order version 1.0, if you like.

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[1] This *Perspectives* is based on comments delivered at the OMGEO luncheon event, *The New New World Order*, held in Sydney on 10 February 2005. It has also benefited from very helpful comments from Allan Gyngell. Any errors of fact or interpretation are the responsibility of the author.

[2] The League of Nations was established by the Treaty of Versailles in January 1919 and its charter and constitution produced by the Paris Peace Conference of that year. The United States never joined the League, and despite some early successes it proved unable to meet its objectives, becoming moribund

In the event, and much like the effectiveness of the League of Nations itself, version 1.0 was relatively short-lived. Moreover, version 1.0 of the new world order also turned out to be a major disappointment from an economic perspective. In particular, it proved unable to resurrect the internationally integrated economy of the pre-1914 period, which had been a sort of golden age of economic integration amongst the developed economies - a 'first age of global capitalism'. Instead, the interwar period was marked by economic dislocation and fragmentation as the international economy splintered into competing trade blocs and the world slid into the Great Depression.

Version 2.0

Efforts to rebuild the international economy were resurrected during the closing years of the Second World War. In the Bretton Woods conference of 1944, Anglo-American policymakers drew on the lessons and failures of the interwar period in order to forge the institutions – the IMF, the World Bank, and the GATT (now replaced by the WTO) – intended to facilitate the reconstruction of the world economy. While these arrangements were not generally described at the time as a 'new world order', it's not unreasonable to categorise the resulting Bretton Woods system as new world order version 2.0.

In its most formal sense – a system of pegged exchange rates between the major global players – version 2.0 came to an end in 1971 with the Smithsonian agreement which devalued the US dollar and broke the link with gold. However, the international institutions that provided the backbone of the Bretton Woods system are still with us: the IMF and World Bank celebrated their sixtieth anniversaries last year and they continue to influence the shape of the international economy, as does the WTO.

The economic environment created and then sustained by the Bretton Woods institutions proved to be remarkably successful in restoring growth and prosperity to the Atlantic economy, as well as in extending modern economic growth to some important 'newcomers' in East Asia. But the Cold War division of much of the world

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with the outbreak of the Second World War. In 1946 the League dissolved itself and was effectively replaced by the United Nations.

into two economic and political blocs meant that new world order version 2.0 was unable to deliver the kind of truly 'global' international economy that had marked the golden first age of global capitalism.

Version 3.0

The next time that the term 'new world order' was actually in wide use – new world order version 3.0 in this schema – was in the early 1990s.

In September 1990, a few weeks after Saddam Hussein had invaded Kuwait, US President George H.W. Bush told Congress that 'out of these troubled times, our objective - a new world order - can emerge.' For the next 12 months or so, the phrase was given a good workout as it came to be associated not just with Gulf War I, but also with the great sense of geo-strategic opportunity afforded by the end of the Cold War: the year (1991) that began with the launch of Operation Desert Storm also ended with the collapse of the Soviet Union.

Importantly, and unlike Wilson's abortive new world order, version 3.0 *was* closely associated with a return to a more integrated world economy. With the fall of the Berlin Wall bringing some 400 million people into the international economy, version 3.0 saw the (re-)birth of a truly global economy for the first time since the First World War.[3] Of course, this new global economy was also the product of sustained, technology-driven falls in transport and communications costs, and of economic policies in both developed economies and emerging markets that placed an increased emphasis on trade and financial market liberalisation.

Moreover, while President George H W Bush's use of the concept of a 'new world order' may have lasted barely longer than the Gulf War I coalition, the economic consequences of the new global economy that was forged over this period are still very much with us. Indeed, a strong case can be made that many of today's most

[3] The end of the Cold War and the collapse of the Soviet Union also contributed at least indirectly to the reintegration of India into the global economy. China's return to the global economy began earlier, with the onset of economic reform in 1978, culminating in WTO accession in 2001.

important international economic policy challenges involve dealing with both the successes and the failures of new world order version 3.0.

The *successes* are perhaps most apparent in the growing international integration of markets for goods, services and financial assets (the labour market still being very much a laggard). They are also visible in the rise to prominence of new economic players in these markets, and in particular in the emergence of China as a great manufacturing and trading power at the start of this century, along with the recent arrival of India's services-based development model. Taken together, these trends are leading to a fundamental restructuring of international trade and capital flows, shifts in the international division of labour, and a geographic redistribution of international economic power.

The *failures* take the form of those economies that have been in some sense 'left behind' by (or in some cases opted out from) the new global economy: failed and failing states, and weak and impoverished ones, which – in an increasingly integrated world – are seen as having the potential to be *systemically* destabilising.

Living in a post-9/11 world

Of course, the policy environment within which these issues have to be tackled has also changed; 9/11 and its aftermath have seen security return to its earlier primacy in international policymaking, marking the end of the interregnum between the Cold War and the War on Terror when international economic policy seemed to be competing for centrestage.

This new environment has had economic implications in the form of a rebalancing in the relative weights accorded security and economic considerations in setting policy, and in the introduction of some impediments to international transactions ('sand in the wheels of globalisation').

But it is hard to make the case that there has been a distinct break in the international economic environment that parallels what we've seen in the security/strategic one. Instead, we are still in a transition phase, with our environment still being shaped by the forces that were released with the birth of a new global economy during new world order version 3.0 – implying, perhaps, that we're currently in version 3.1 – although it does seem likely that the result of these forces will in the end be the creation of a new, new world order, or version 4.0.

Five international economic policy challenges

These forces of transition will have important implications for international economic policy over coming years. Here we focus on just five of the main policy challenges that are likely to result: managing global imbalances, coping with deeper economic integration, reinforcing the international economic architecture, ensuring energy security and delivering economic development.[4]

1. Managing global imbalances

The first of these major international economic policy challenges is the need to manage global economic imbalances, specifically the massive US current account deficit and its counterpart surpluses in the rest of the world.

This seems to be a natural place to start, since one crucial element that *hasn't* yet changed is that the United States remains at the heart of the world order, new or not. As well as being the world's dominant military power, the US also boasts the world's largest economy (accounting for about 30% of world GDP in 2003) and is also the largest trading nation (accounting for more than 13% of world trade in the same year).[5]

Intriguingly, however, this still-mighty US economy is now increasingly reliant upon the kindness of strangers. Or, in the more dramatic words of former US Treasury Secretary Larry Summers, upon a 'balance of financial terror.' The US current

[4] This list is not intended to be exhaustive. For example, one important challenge not included here is dealing with the consequences of global demographic transition and the resultant ageing of the world's population.

[5] Output measured using market exchange rates (on purchasing power parity exchange rates, the US dollar share falls to 21%). On this measure the second largest economy, Japan, accounted for just 12% of world GDP, or was less than half the size of the US economy. Germany, the world's second largest merchandise trader in 2003 accounted for a little less than 9% of total world trade.

account deficit last year reached record highs, running at well over US$600 billion on an annualised basis, or equivalent to more than 5½ % of US GDP, requiring more than US$2½ billion of external financing every working day in funds that were increasingly being sourced from (East) Asia's central banks.

To date, funding this external shortfall has not proved much of a problem – indeed some analysts have claimed that the world economy has effectively seen the resurrection of something like the old Bretton Woods model – a 'Bretton Woods 2'. The argument here is that since both sides benefit from the current arrangement (the US receives external financing from East Asia, which in turn gets to artificially sustain competitive exchange rates that allow it to maintain or gain market share in the vast US market) the current situation is perfectly sustainable. Another claim with similar implications is that the greater integration of global capital markets has made funding a given deficit much easier than in the past, with the US now better able to tap a much-expanded pool of global savings. In fact, there is probably something to both views, but the conclusion that sustainability is not an issue is almost certainly too optimistic, and is apparently not shared by a US Federal Reserve which seemed to be doing its best to 'talk down' the US dollar since the last quarter of last year.

A key short term international economic policy challenge for both George W Bush's second term and for the international economy as a whole therefore is how to manage US external adjustment and its counterparts in the rest of the world. One possibility that occasionally receives some attention – normally around the time of G7 finance ministers meetings – is some attempt to achieve international policy coordination in the form of a new Plaza Accord.[6] But since the debate over how the (nominal) exchange rate adjustment to a falling US dollar will be distributed internationally is yet to be settled, this looks unlikely. These is too much scope for disagreement between Washington, Brussels, Tokyo and Beijing, with euro-area policymakers worried that their already weak growth prospects are being dented by the euro taking an 'unfair' share of the currency appreciation burden, Tokyo concerned that a stronger yen would undermine its anti-deflation efforts, and many of the economies of East

[6] The Plaza Accord was a formal announcement in September 1985 by economic officials of the G5 that they would jointly intervene in currency markets in order to produce a dollar depreciation. The Louvre Accord (February 1987) later announced efforts to stabilize exchange rates around the levels then prevailing, although any stability lasted only until the October 1987 stock market crash.

Asia yet to accept the case for currency appreciation and at least some move away from their current quasi-mercantilist, export-led growth model. This suggests a continued market-driven correction is more likely.[7]

How might such a correction play out? One scenario is that the world in effect gets a re-run of the 1980s, even without a Plaza Accord. The parallels are often cited: a Republican president, twin budget and current account deficits, and trade tensions with a major Asian economic power. A dollar 'crash' back then had a fairly benign outcome: despite a 30-40% fall in the trade-weighted value of the greenback, the hit to the US and to the world economy was relatively modest (although the sharp yen appreciation at this time probably contributed to Japan's subsequent economic malaise, something that Beijing is no doubt well aware of when facing pressure to revalue the RMB).

Several observers have noticed that there are *also* strong parallels between the current situation of the US economy and the one prevailing in the early 1970s: budget and current account deficits, accommodative monetary policy, open-ended security commitments (with Vietnam filling in for Iraq and Homeland Security), and pressures on energy prices. Some form of re-run of the 1970s experience would imply a much grimmer outlook for the world economy than the 1980s precedent . . . with potential parallels including the collapse of another Bretton Woods arrangement (Bretton Woods 2 this time around). In the event of this sort of scenario playing out, and if things went *badly* wrong, there could even be implications for the structure of the international financial system including the future role of the dollar relative to the euro, for example.

Finally, there are also important linkages between domestic and international economic policies at play here. In recent policy statements President George W Bush has made it clear that the priorities of his second term will include tax and social security reform. Yet these also imply greater pressure on a US budget deficit which

[7] There is also a debate here about to what extent adjustment will occur (at least in the absence of significant fiscal consolidation - cue *another* debate on the links between the budget and current account deficits) directly through a fall in the dollar or indirectly through significantly higher US interest rates, much of which will be endogenous to a dollar fall. There is a non-trivial risk that the US and global economy is ill-prepared to deal with sharply higher real interest rates relative to current expectations.

finished last year at more than 3.5% of GDP and which seems to be stuck above US$400 billion. This in turn would have adverse implications for the current account and hence the dollar.[8]

2. Coping with deeper economic integration

A second international economic policy challenge is the continuing need for policymakers to manage the consequences of deeper international economic integration. The combination of policy liberalisation and falling communications costs is accelerating the creation of international production chains, with multinational corporations and foreign direct investment forging these new global economic links.

One consequence of these trends is the increasingly 'footloose' nature of capital, which is ever more able and willing to cross national borders in the search for return – a development that is apparent in the shift of large chunks of global manufacturing to China. Another is the growing 'tradeability' of services, which will have major implications for employment and productivity in both developed and emerging economies. While these developments are good news for the long term health of the global economy taken overall, there is little doubt that they are also likely to throw up significant local political challenges, given the potentially substantial transition costs that will be involved.

3. Reinforcing the international economic architecture

A third challenge is the need to reinforce the international economic architecture in order to better manage the economic forces unleased by the new global economy. This task is complicated by the fact that while the US may be enjoying a 'unipolar moment' in terms of its military capabilities, US *economic* predominance is not quite so clear-cut; the euro may now be challenging the pre-eminence of the dollar in currency markets, for example, while the emergence of new economic players like China and India is at the early stages of changing the balance of economic power in

[8] The tabled proposals to reform social security imply an increased fiscal deficit unless either they are financed by either cutting benefits to existing retirees and/or by increasing taxes. Conventional wisdom has it that neither is on the agenda, so debt-financing looks the most likely option at present.

the world economy.[9] One example of the growing importance of economic developments in other parts of the global economy is the way in which a large portion of the debate over global external adjustment has focused on the future of China's RMB policy. Another is the debate that raged for much of last year on whether the Chinese economy would manage a hard or a soft landing.[10] This means that the ability – and potentially the willingness – of the US to exert economic leadership is much more constrained that it was during (say) the creation of the Bretton Woods system after the Second World War.

The strains and pressures generated by these shifts in the international balance of economic power inevitably mean that current international arrangements – which are a legacy of the post-World War Two era and the dominance of the Atlantic economy – are in need of attention.

One area where the need for a rethink looks particularly pressing is the world trading system. The Bush administration helped launch the Doha Round in 2001 and after the talks ran into a brick wall in Cancun in 2003, partly in response to emerging market economies flexing new-found muscles, US economic diplomacy played a key role in getting things up and running again in Geneva last year. This year's Hong Kong ministerial meeting in December will be another important landmark for the Doha Round, and a failure along the lines of Cancun could fatally damage the current trade round, and possibly the current multilateral trading system. US leadership will again be vital in keeping Doha alive. Moreover, it will also be vital past the Doha Round, as the need for institutional change in the multilateral system is set to grow ever more pressing. But as already noted the space within which that leadership can be exercised is becoming more constrained.

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[9] China is well-ahead of India on this count. China probably became the world's fourth largest trading economy in 2004, and is on track to become the world's fourth largest economy in US dollar terms (its already number tow in PPP terms). China is also now the world's largest consumer of several minerals including copper, tin, zinc, platinum, and iron ore, and is the second largest energy consumer in the world.

[10] That debate may still not be over. The consensus at present seems to be that China has already managed a soft landing. However, with growth in the final quarter of last year not showing much of a slowdown, arguably the most that can be claimed at this point is that there has been a rebalancing (in the sense of a relative slowing in investment, and a relative increase in consumer spending as measured by retail sales) in Chinese growth.

There is also a more general case for rethinking either the membership of some of the bodies that currently seek to manage the international economy (seen in the case for replacing the G-7 with the broader G-20 which includes major emerging economic powers like China and India) or the voting weights (for example the International Monetary Fund, where Western Europe is relatively over-represented, and Asia relatively under-represented, relative to their current weight in the global economy).

4. Ensuring energy security

A fourth international economic policy issue is energy security. Another consequence of one of the major successes of the global economy – strong economic growth, rapid industrialisation, rising living standards and increasing urbanisation in the billion-people plus economies of China and India – is increasing demand for resources in general and for energy in particular. Thus China is already the second largest consumer of energy in the world (after the United States), while India has moved into sixth place, and both countries are likely to see their role in global energy markets continue to rise.

Some early indications of how these developments could play out were visible last year in the oil market. China's demand for oil has doubled over the past decade, and in 2003 China overtook Japan to become the world's second largest oil consumer, accounting for almost 8% of global oil consumption, while in 2004 it is estimated that China was the source of around one-third of the increase in world consumption, which in turn contributed significantly to the fastest annual increase in global oil consumption since the 1980s.[11] While most experts agree that the world is unlikely to run out of oil in the next couple of decades, the combination of increasing demand and a growing concentration of remaining supply in the Middle East mean that the risk of *disruption* to world energy markets is now a significant one. And as economic history shows, oil shocks can have major effects for the health of the world economy.

[11] According to the US Energy Information Administration, China has been the source of around 40% of the growth in world oil demand over the past four years. India was the world's sixth largest oil consumer last year (accounting for 3.1% of world consumption) and has seen its demand for oil grow by more than 80% over the past ten years.

5. Delivering economic development

While the previous four policy challenges largely relate to managing the successes of the new global economy, the final policy challenge highlighted here relates to one of its failures; specifically, the failure to deliver economic development to a still-substantial part of the world's population. Roughly half of the world still lives on less than US$2 a day, and in some regions, particularly Africa, signs are that human welfare is going backwards, with the risk that the spread of HIV-AIDS could lead to the collapse of some African countries, for example. 2005 has been flagged as a year in which the developed economies will increase their focus on development, with September bringing a UN summit to assess progress towards the so-called Millennium Development Goals (MDG).[12] Achieving success in the Doha Round – the so-called Development Round – can make an important contribution here, although the gains for the world's poorest economies from even a successful Doha are likely to be limited at best. Recent experience with development policy and international aid has been sobering, with no easy policy solutions in sight. Development institutions such as the World Bank, for example, have been claiming that a turnaround in Africa is 'just around the corner' for more than two decades now.

Implications for Australia

Clearly some of the general challenges identified above, such as managing external imbalances, dealing with deeper economic integration and the future of the international economic architecture have important implications for Australia. Global adjustment to external imbalances and the future path of the US dollar obviously have consequences for the A$, and hence for the economy more broadly; A$ strength is frequently cited as an explanation for the relatively lacklustre performance of manufacturing exports recently, although increased global competition has also probably played a role. And of course whether the adjustment to global imbalances is

[12] The Millennium Development Goals (MDGs) are targets established in 2000 by the UN with the aim of improving the situation in developing countries. There are eight goals, most of which target improvements by 2015 relative to a 1990 base year. These goals are (1) eradicate extreme poverty and hunger; (2) achieve universal primary education; (3) promote gender equality and empower women; (4) reduce child mortality; (5) improve maternal health; (6) combat HIV/AIDS, malaria and other diseases; (7) ensure environmental sustainability; and (8) develop a global partnership for development.

smooth or abrupt has implications for global and hence Australian growth, and – perhaps – for the financing of our own current account deficit.

Similarly, some of the challenges posed by deeper integration were visible in the public and policy debate over whether Xstrata's bid for WMC should be allowed to proceed.

But to what extent can the argument for a new, new world order be applied to Australia's international economic environment, and the policy challenges implied, in particular in regard to the region?

During the early years of the 1990s – the time of new world order version 3.0 and the forging of the new global economy – Australia under Prime Minister Paul Keating sought to take advantage of the change in global circumstances to deepen the relationship with Asia. The end of the Cold War had allowed the integration of Indochina (Vietnam, Laos) into the ASEAN framework while China was also beginning to take a more prominent role on both the global and regional stage. With the East Asian economy booming, the region seemed to be a natural focus for international economic policy, including for initiatives like APEC's Bogor Goals (1994).[13]

Following the change of government in 1996 Australia's international policy priorities shifted away from the region in relative terms. In part, this reflected a change in emphasis under Prime Minister John Howard that combined a different philosophy with a new government's urge for 'product differentiation'. Subsequently, however, the extra-regional focus was reinforced by the pressure of events, including the 1997-98 Asian financial crisis and then 911 and the Iraq War. As a result, the US has been the major focus of international policy during John Howard's tenure as prime minister. In international economic policy terms this culminated in the Australia-United States Free Trade Agreement (AUSFTA) signed last year, an agreement that was at least as much about geopolitics as it was about economics.

[13] The Bogor Goals call for free and open trade and investment in the Asia-Pacific region by 2010 for industrialised economies and 2020 for developing economies. The goals were adopted by APEC Leaders at their 1994 meeting in Bogor, Indonesia.

With AUSFTA now out of the way and the US alliance in good shape, Howard's fourth term is set to see a relative increase in the focus on Asia. The scale and scope of the government's commitment to provide aid to Indonesia to deal with the aftermath of the Tsunami is one early sign of this increased emphasis on regional engagement.

One of the major ongoing challenges for Australia in the region is to adapt and respond to the emergence of a new *regional* order: that is, a regional environment that is increasingly being moulded by the growing economic and political weight of China, and by the response of other regional economies to that weight. This Chinese 'gravitational pull' is reshaping both regional trade flows (visible in the expansion of intra-regional trade) and regional institutions (apparent both in the growing role of ASEAN+3 and the spread of regional trade deals). Australia's relationship with China, already one of our major trading partners, is therefore set to be increasingly important, whether in terms of bilateral trade flows, the evolution of the regional economic architecture, or in the strategic relationship with the United States. The proposed Australia-China FTA – the scoping study for which is due to be concluded by end-March 2005 – will be one major contribution of international economic policy that has the potential to have implications across several facets of the relationship.

More generally, the proposals for future trading agreements with Malaysia and with ASEAN more broadly (in addition to existing agreements with members Singapore and Thailand) also fit into the pattern of renewed regional engagement, and into the broader theme about changes and adjustments to the international economic architecture. For example, an increasingly pressing issue for both Australia and the region will be how East Asia's decision to finally climb on board the preferential trade bandwagon will influence the health of the multilateral trading system.

Another area where there is overlap between regional and global concerns relates to rebuilding failed states and encouraging economic development. Australia is the regional superpower of the Southwest Pacific, and is now embarked on a more activist and interventionist policy approach, as embodied in the establishment of the Regional Assistance Mission Solomon Islands (RAMSI), and in the resolution to commit additional resources to the new Enhanced Cooperation Program (ECP) with PNG. This new approach, if it is to be sustained, implies a long-term commitment of resources and attention that will almost certainly span several changes of government. A noteworthy development here is the changing nature of Australia's engagement with both Southeast Asia and the Southwest Pacific. One feature of both the tsunami relief package for Indonesia and the ECP in PNG for example is the importance of economic links: Treasury and Finance are now on the ground in both economies, working directly with their local counterparts. This in turn indicates a widening of Australia’s policy interests beyond trade to matters of economic governance.

To conclude, whether or not we are operating in a new, new world order, or are in the process of moving towards one, is still a debatable point. But there is little doubt that the current international economic environment poses several challenging policy issues, both for Australia and for the world as a whole.

About the Author

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