An unstable economic order?

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The retreat of the advanced economies from the global economy - and, in the case of the United Kingdom, from regional trading arrangements - has received a lot of attention lately. At a time when the global economy's underlying structures are under strain, this could have far-reaching consequences.

Whether by choice or necessity, the vast majority of the world's economies are part of a multilateral system that gives their counterparts in the advanced world - especially the United States and Europe - enormous privileges. Three stand out.

First, because they issue the world's main reserve currencies, the advanced economies get to exchange bits of paper that they printed for goods and services produced by others.

Second, for most global investors, these economies' bonds are a quasi-automatic component of portfolio allocations, so their governments' budget deficits are financed in part by other countries' savings.

The advanced economies' final key advantage is voting power and representation. They command either veto power or a blocking minority in the Bretton Woods institutions (the International Monetary Fund and the World Bank), which gives them a disproportionate influence on the rules and practices that govern the international economic and monetary system. And, given their historical dominance of these organisations, their nationals are *de facto* assured the top positions.

These privileges don't come for free - at least, they shouldn't. In exchange, the advanced economies are supposed to fulfill certain responsibilities that help ensure the system's functioning and stability. But recent developments have cast doubts on whether the advanced economies are able to hold up their end of this bargain.

Perhaps the most obvious example is the 2008 global financial crisis. The result of excessive risk-taking and lax regulation in the advanced economies, the financial system's near-meltdown disrupted global trade, threw millions into unemployment, and almost tipped the world into a multi-year depression.

But there have been other lapses, too. For example, political obstacles to comprehensive economic policymaking in many advanced economies have undermined the implementation of structural reforms and responsive fiscal policies in recent years, holding back business investment, undermining productivity growth, worsening inequality, and threatening future potential growth.

Such economic lapses have contributed to the emergence of anti-establishment political movements that are looking to change – or are already changing – long-established cross-border trade relations, including those within the European Union and the North American Free Trade Agreement (NAFTA).

Meanwhile, a prolonged and excessive reliance on monetary policy, including direct central-bank involvement in market activities, has distorted asset prices and contributed to resource misallocation. And the advanced economies – particularly Europe – have shown little appetite for reforming outdated elements of governance and representation at the international financial institutions, despite major changes in the global economy.

The result of all this is a multilateral system that is less effective, less collaborative, less trusted, and more vulnerable to ad hoc tinkering. Against this background, it should not be surprising that globalisation and regionalisation no longer command the degree of support they once did – or that some rising political movements on both sides of the Atlantic are condemning both concepts to win more support for their own causes.

It is not yet clear whether this is a temporary and reversible phenomenon, or the beginning of a protracted challenge to the functioning of the global economy. What is clear is that it is affecting two important relationships.

The first is the relationship between small and large economies. For a long time, small, well-managed, and open economies were the leading beneficiaries of the Bretton Woods system and, more generally, of multilateralism. Their size not only made them crave access to outside markets, it also made other market actors more willing to integrate them into regional pacts owing to their limited displacement potential. Membership in effective international institutions brought these countries into consequential global policy discussions, while their own capabilities allowed them to exploit opportunities in cross-border production and consumption chains.

But, at a time of surging nationalism, these small and open economies – however well managed – are likely to suffer. Their trading relationships are less stable; the trade pacts on which they depend are vulnerable; and, their participation in global policy discussions is less assured.

The second relationship is that between the Bretton Woods institutions and parallel institutional arrangements. For example, while they pale in significance to, say, the World Bank, China-led institutions have proved appealing to a growing number of countries. Most US allies have joined the Asian Infrastructure Investment Bank, despite American opposition. Similarly, bilateral payment agreements – which, not long ago, most countries would have opposed via the IMF owing to their inconsistency with multilateralism – are proliferating. The concern is that these alternative approaches could undermine, rather than reinforce, a predictable and beneficial rules-based system of cross-border interactions.

The Bretton Woods organisations, instituted after World War II to maintain stability, now risk losing their influence, and the countries with the clout to bolster them seem unwilling at this stage to press ahead boldly with the needed reforms. If these tendencies continue, developing countries will probably suffer the most. But they won't be alone. In the short term, the world economy would face slower economic growth and the risk of greater financial instability. In the longer term, it would confront the threat of systemic fragmentation and proliferating trade wars.

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