UNIT 3 THE GLOBAL ECONOMY AND FINANCIAL ARCHITECTURE (IMF, WORLD BANK)*

Structure

3.0 OBJECTIVES

In this Unit, you will be introduced to the global economy including to its various stages; concept of liberalism and its evolutionary phases; and finally the global financial architecture comprising of International Monetary Fund (IMF) and the International Bank for Reconsruction and Development (IBRD), commonly called the World Bank. After going through this Unit, you should be able to:

- Understand global economy through its various stages;
- Explain neoliberalism – the concept and policies prescriptions;
- Describe and discuss the global financial architecture including the working of IMF and the World Bank.

3.1 INTRODUCTION

The global economy has witnessed unprecedented transformations in the last three decades or so. There is lots of flux around – economic and financial. Manifestation of this, for example, are the global economic crisis of 2008-09, the increasing role of the Global South in the world economy and most recent tide of protectionism and populism in the developed economies, particularly generated by the Brexit vote and US President Donald Trump's 'America First Policy'. These developments have reinvigorated the debate on economic globalisation and international financial architecture. Admittedly, the ambit of global economy has also expanded over the years. The world has shrunk due to

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globalisation, spinning an interconnected nature of politics and economics at international and global levels. Political factors along with economic factors have come to play a significant role in shaping global economy. Despite the fact that there exists reciprocal influence of economic and political factors; this interaction has been transformed in fundamental ways over the past several centuries. This is particularly the result of increasing interdependence of economies because of enhanced flows of trade, finance, and technology. Markets operate under the principle of competition in a globalized world, creating complex interdependence.

What is meant by global economy? The present Unit on global economy addresses this question and highlights aspects of interplay of economics and politics and the global economic interconnectedness – the way it has evolved to the present times. In fact, global economy has evolved over centuries with change in ideas and practice. Modern global economy has gone through the age of mercantilism; industrial revolution and the period between the two world wars which was marked by protectionism and the Great Depression of 1929. The present Unit describes and analyzes the ideology of neoliberalism. A discussion of neoliberalism is preceded by a short historical account of liberalism and its salient manifestations. Finally, the Unit explains the global financial architecture including the organization and working of the IMF and the World Bank.

3.2 STAGES IN GLOBAL ECONOMY

Before understanding the evolution and various stages modern global economy has passed through, it is necessary to first understand the meaning and importance of the subject. Global economy can be described as the intertwined economic activity of various countries which can negatively or positively impact one another. However, global economy cannot be understood in absence of the political developments that have happened in a given timeframe. This interplay of economics and politics helps us to understand and analyze the shape and the working of global economy. The relative influence of the state and market in defining global economy has been recognised by scholars of International Relations. The reciprocal influence of state and market in the working of global economy has been aptly described by Robert Gilpin in his *The Political Economy of International Relations*: "…the state and the associated political processes affect production and distribution of wealth and, in particular, … political decisions and interests influence the location of economic activities and the distribution of costs and benefits of these activities."

Given the unprecedented transformation that has come about in the world economy, Robert Gilpin describes in some details the dynamic interplay between economics and politics that has historically characterized global economy. Foremost, he notes the aspect of reciprocity between economics and politics. He elaborates it as follows: (i) state exercises its power to determine the framework of economic activity. Once done, state policies further direct overall economic activities in ways which benefit the dominant groups. The way state exercises this power determines the nature of an economic system. (ii) Gilpin further states that economic process itself tends to redistribute power and wealth. He observes that "the dynamics of international relations in the modern world is largely a function of the reciprocal interaction between economics and politics".

3.2.1 Age of Mercantilism (1500-1750)

The emergence of modern global economy dates back to beginning of the sixteenth century. The period 1500 -1750 is called the age of mercantilism. Sometimes, the period is also described as 'early capitalism' or 'trade capitalism'. It is the age when Europe began exchanging goods with the other continents of Africa, Asia, Americas and Australia. The growth in intercontinental shipping facilitated the expansion of transcontinental trade in the 16th century. Emergence of Dutch and British colonial trade in the 17th century raised the level of European trade with the outside world. The global trade and its expansion were made possible by the strong monarchical states of Europe. Remember the axiom: global trade thrives when powerful states protect it; it falls when they don't. Be that as it may, global trade facilitated the development of a world market economy.

But what is mercantilism? Mercantilism is not an ideology; rather it is a combination of various principles and practices which different countries of Europe adopted at different times thinking that they were in their national commercial interest. Some of the beliefs and principles that mercantilist states held very dear and practiced for some two-and-a-half centuries were: (i) Gold, silver and other precious metals owned by a state is an indicator of its wealth. (ii) A state should export more than it imports so as to have a favourable balance of trade; and thus to acquire more precious metals. (iii) There are upper limits to the expansion of global trade. It was believed that European trade by 17th century has attained the optimal level; henceforth it will only stagnate. (iv) The larger the population, the stronger and self-sufficient would be the state. (v) State, or crown, has a dominant to role in the making and direction of national and international economies. Strong monarchy should just nor control the economy but also shape the political order and social hierarchy.

Mercantilist economy had the following features: (i) Barter system disappeared. By the end of 15th century, money economy arose as national, regional and international trade grew. Currency became the order of the day. European currencies became very powerful and their circulation increased in far-away places. The adage that 'money means wealth' originated in the age of mercantilism. It was believed that a moneyed man could command influence and acquire goods and services of his choice. (ii) Large and powerful nation states were formed in Europe. They bulldozed small states and principalities in the name of carving up a 'nation i.e. people said to be having a common descent, language, culture, history etc. Large nation states produced large bureaucracies and armies to fight frequent wars for resources and markets. These developments and huge court expenditures meant need even for more money, which in turn meant need for more metals such as gold and silver. Bureaucratic careers were the most lucrative; and mercantilist wars spread across Europe and overseas. (iii) Foreign trade, not domestic trade, was viewed as the preferred method to obtain gold, silver and precious metals and minerals. Foreign trade in manufactured goods was preferred over agricultural goods. (iv) This was the age of discovery. The discovery of the Americas in 1492 by Columbus and sea route to India by Vasco da Gama in 1497-99 opened tremendous opportunity to obtain such wealth. European explorers connected the west with the east – this brought to an end trade on the silk roads as well seaborne spice trade. The need to have ever more wealth continued to rise up and up; in turn, more and more wealth was required to conquer and protect overseas colonies and trade. Age of mercantilism was made possible by new scientific discoveries and innovations. This was the age of "scientific revolution" in the fields of astronomy, mechanics, physics and shipping. The scientific discoveries and inventions aided the discoveries and creation of colonies by the Portuguese, Spanish and later the Dutch and the English. Circumnavigation of the Earth was one of the biggest feats of its time: it brought about integration of global economy. Discovery of new lands and introduction of new crops created the institution of African slavery – a legacy that continues to manifest itself in many ugly ways to this day. (v) Mercantilism demanded more and more royal control over both the internal and external economic policies of the state; this gradually facilitated the transition from strong monarchies to absolutist states. Moreover, as colonies grew in number and expanded in size, it was deemed legitimate to exploit their resources and people for the benefit of the 'mother' countries. "All of these factors ensured that the rising late medieval and early modern states embraced mercantilism as an economic theory that allowed them to adapt to and seek to exploit these shifting structures" (Source: "Europe, 1450 to 1789", *Encyclopedia of the Early Modern World*).

The age of mercantilism came to an end around mid-18th century. New economic ideas discredited the mercantilist assumptions and ideas. The most influential was the idea of a laissez faire economy. The theory of laissez faire rejected the two main assumptions of mercantilist capitalism: the availability of gold and other precious metals is limited; and that there is an upper limit to global trade which Europe has already reached. David Hume and Adam Smith were the main proponents of laissez faire. David Hume (1711–1776) sought to identify the natural advantages that various nations enjoyed in the flow of commerce and provided a new theory on international trade. Adam Smith's (1723–1790) argued that world wealth was not static; and that the principle of comparative advantage worked in international trade. Profit motive i.e. the 'invisible hand' of the market makes human to labour.

3.2.2 Industrial Revolution

The Industrial Revolution marked a major shift in the technological, socio-economic, and cultural conditions in the late eighteenth and early nineteenth century Europe. Industrial Revolution began in Britain and spread throughout the world – a process that continues even now as industrialization.

What caused the Industrial Revolution? The question remains largely unanswered in social sciences. Many theories have been put forward. Suffice to say, it originated from the social and institutional changes left behind by the declining feudalism in England after the English Civil War in the seventeenth century. However, everyone agrees that Industrial Revolution was made possible by technological innovations; and the key enabling technology was the invention of steam engine.

Historians also differ as to when it started? Eric Hobsbawm is of the view that Industrial Revolution 'broke out' in the 1780s and was not fully felt until the 1830s or 1840s. In other words, one can say that Industrial Revolution refers collectively to the technological changes that took place over five to six decades; and even after.

However, every one concurs about its profound impact. No denying, Industrial Revolution is a major turning point in human social history. Its impact has been huge and on all aspects of life and society – wealth; social life; and politics:

i) It led to an unprecedented increase in production and consumption, and thus in per capita wealth.

ii) Industrial Revolution gave birth to a new social order: by the early decades of the 19^{th} century, there was a strong middle class of industrialists and businessmen had that had triumphed over the class of landowners and nobles. Large population had moved to factory sites where they became the factory workers. According to Karl Marx, industrialization divided the society into two classes: the bourgeoisie (those who own the means of production) and the proletariat (the working class).

iii) Writing in 1844, Friedrich Engels noted that Industrial Revolution had greatly changed the civil society in England. Soon, the tax payers demanded the franchise right. Use of steam power in printing press facilitated massive expansion of newspaper and popular book publishing. Easy access to printed material raised literacy; and further to demands for popular political participation. Right to vote was granted to more and more number of people in Britain under Reform Bills of 1832, 1867 and 1884-85.

iv) Other changes were equally profound: spread of scientific temperament and scientific enquiry. Scientific knowledge began to be applied to social issues. An example of the empirical and scientifically researched work was Adam Smith's *The Wealth of Nations*. One of his main arguments for capitalism is that industrialization increases the wealth for all, as borne out by rising consumption and life expectancy in England.

A brief description of the ideas of Adam Smith on the virtues of free market capitalism would be helpful. (i) Adam Smith saw modern industries working on the basis of division of labour. He said that division of labour enabled factories to raised both production and productivity of their workers. (ii) Economies follow the path of comparative advantage in order to register growth and prosperity. (iii)He argued that people have a natural drive to improve their own lives. This self-interest propels markets to satisfy individual demands by producing goods and services. He called this the 'invisible hand'. For example, it is not benevolence but self-interest which makes a baker provide bread to consumers. (iv) He suggested that competition between businesses is good. Competition keeps producers honest. Customers can avoid a dishonest seller and patronize an honest one. Competition ensures fair price, quality of product, and economic innovation.

3.2.3 Global Economy and Trade until 1945

It was in the age of mercantilism that Europe began exchanging goods with the other continents of Africa, Asia, Americas, and Australia. For four centuries until the outbreak of the First World War in 1914, the intra-European trade remained most significant in the overall global trade. Technological innovations facilitated overseas trade and colonial expansion. From the mid-18^{th} century, seaborne trade experienced strong growth.

From Industrial Revolution until the First World War, three European powers viz. Great Britain, Germany and France dominated the global economy. The three also determined the Europe's commercial links with the world outside. They accounted for more than three-fourth of the industrial production of Europe and more than three-fourth of Europe's trade with rest of the world. All the three economies had high level of productivity and competitiveness about them. This made them export a lot of industrial products and import raw materials. Until the break of the First World War, the three also dominated the international flow of capital and direct foreign investment. Great Britain was the centre of global capital market and it came up with trade and financial innovations. Bank of England followed the principle of the gold standard in all money and capital markets of the world. France formulated new norms and laws which brought lots of rationalization to global financial and fiscal matters. Various measures were adopted: such as standards in the areas of measures, coinage and weights, as well as currency and bank reforms etc, anti-protectionism, and dissolution of merchants' guilds. The spread of laissez faire ideas in 18th century provided a strong impetus to global trade and connectivity. Several free trade agreements were signed in the 18th century; the principle of most favoured nation (MFN) was formulated and practised by trading nations.

All these measures and developments brought lots of stability and security to global trade. European economies were very diverse. With high productivity and competitiveness about them, European economies began specializing in particular areas. For instance, Germany took to innovations; and by the late 19th century was the world leader in steel production, railway equipment, heavy machinery and electrical engineering. A liberalized trading system boosted both internal European trade and trade between Europe and the rest of the world. A new international division of labour came into being: Europe exported manufactured products, capital and machinery; in return, it sourced raw materials from colonies and underdeveloped regions of the world.

In early 20th century, two events proved devastating for the global free trade system. First World War damaged it; it became impossible to resurrect the system after the war. The international currency system had disintegrated; in 1914 countries such as Russia, Germany and France had abandoned the convertibility of their currencies into gold. The Great Depression of 1929 was the second blow to the global free trade: global trade volume declined by 26 per cent and European trade by 38 per cent. Major European economies turned nationalist; and practiced protectionism and trade discrimination. The outbreak of Second World War further blocked the circulation of goods and capital within Europe. European countries had to pay a heavy price for converting factories from peacetime to wartime production; for naval blockades; and for high cost of transactions. Moreover, when war ended, Europe found itself split between the liberal capitalist and communist camps. In brief, the liberalized trade regime was abandoned altogether in the period between the two world wars.

The inter-war period brought in other very significant changes in the global economy. The First World War moved the axis of global trade from Europe towards United States. The influence and role of the US in global economy and finance grew exponentially after 1918. Post-1929 world depression, US was in the driver's seat as far as global economy and trade was concerned. When Europe plunged into economic depression in 1929 and its share in global trade fell, other industrialized economies such as the US, Canada and Japan saw their share of the global market increase.

After the Second World War, US came to the rescue of Europe. It launched Marshal Plan to rebuild European economies. This involved restoration of industries, establishing a monetary order and integration of Europe once again with the global economic order, now led by the US. Marshall Plan was a success and Europe returned to impressive export-led economic growth. An international financial and trade architecture was also envisaged along liberal economic lines.

Check Your Progress Exercise 1

Note: i) Use the space given below for your answer.

ii) See the end of the unit for tips for your answer.

1) Describe the principles and practices of mercantilism.

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2) Discuss the impact of Industrial Revolution.

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3.3 ANTECEDANTS AND THE IDEOLOGY OF NEOLIBERALISM

What is definition of neoliberalism and what has been its history? Does neoliberalism mean revival of liberalism? Not many have bothered to enunciate and explain the ideology of neoliberalism. It is critics who often decry neoliberalism: it is equated with profit-making, consumerism, disregard to environment, a capitalist economy with no restrictions on the market forces, and where state has abandoned the goal of social welfare.

Neoliberalism should not be confused with liberalism; much less its revival. Neoliberalism is a distinctive ideology; though it shares some of the historical roots and some basic vocabulary with liberalism. Liberalism as political philosophy has several traditions. One of them is economic liberalism. One can say that it is economic liberalism that comes closest to neoliberalism in contemporary times; albeit still with a difference. As is known, economic liberalism holds the view that state ought not to intervene in economy. Instead let the individual freely operate in market economy which is free and self-regulating.

To repeat once again, don't combine neoliberalism and economic liberalism with liberalism. Neoliberalism is an ideology different from and, in fact, often opposed to 'liberalism'. Let us have a brief look at liberalism and its various phases and dimensions.

3.3.1 Liberalism

The philosophy of liberalism stands for many things: democracy, constitutional government, rule of law, individual rights, a capitalist economy, etc. It emerged as a response to the Industrial Revolution and urbanization in 19th century Europe and the United States. These liberal values remain part of the Western discourse at least since the end of the Second World War.

The history of liberalism as philosophy is fairly old and varied. The concept has become nebulous over time; besides, there is not one but several types of liberalisms. From John Locke, Adam Smith, John Stuart Mill and contemporary philosopher such as Isaiah Berlin and John Rawls all are liberals but with profound differences among them on issues such as the virtues of democracy, limits to individual freedom, the idea of welfare state and equation between state and market. Be that as it may, one simple distinction often made is between 'classical' and 'modern' liberalism.

i) *'Classical' Liberalism*

From the 17th and 18th century philosopher John Locke and Adam Smith to 20th century philosopher Friedrich von Hayek all belong to the tradition of 'classical' liberalism. 'Classical' liberalism holds the view that state ought to do minimal, such as law and order and defence. All else should be left to the free choice of the individual and the organizations he establishes and participates in. Let the market forces to shape the economy; state is only a 'night watchman'. 'Classical' liberalism as described above thus has close connection with economic liberalism (but the two are not interchangeable terms). 'Classical' liberals without exception support the laissez faire economic policies – a philosophical position championed by neoliberals of today. 'Classical' liberals believed that free market economic policies would ultimately produce all-round prosperity and promote individual freedom and democracy.

Classical liberalism championed the cause of industrialization during the 19th century. Raising the banner of individual freedom, the entrepreneurial class of industrialists and merchants deployed its energies to expand the production and vastly increased its wealth. The belief in laissez faire was at the core of classical liberalism; and it was considered a panacea as British and other European economies boomed.

Towards the end of 19th Century, the faith in the laissez faire had run its full course. The idea stood discredited; so much so that many were even questioning the feasibility of capitalism as an economic model. Industrialization had allowed production of lots of goods and services but there were not many who could afford to buy them. Markets were glutted with products; but with only few who could buy. The entire production system periodically came to a halt in times of stagnation. These prolonged periods of no purchase and stagnant production came to be called depressions. Working under the ideology of laissez faire, governments did nothing. In any case, governments only did the bidding of the wealthy class of industrialists and merchants. There were other unforeseen consequences of Industrial Revolution: concentration of wealth; low income of the working class; and urbanization with impoverished population. The irony of the situation was no lost: the very forces that had once released the entrepreneurial energies now restrained them. And those who had once championed individual freedom and limited governments now practiced despotism.

ii) *Modern Liberalism*

An important principle of the working of capitalist economy had been established by the end of the 19th century: capitalist economy goes through boom-and-bust cycles. Periodic stagnation is part of the business cycle of a capitalist economy; and market alone cannot fix it. It was also established that the philosophy of laissez faire has no solution to offer for economic depression. The British political philosopher T. H. Green also noted that inequality, ignorance and poverty are new types of impediments that endanger individual freedom and make the governments despotic. An individual cannot overcome these hindrances through his efforts alone. Green wrote that these impediments to freedom could be tackled only with the positive assistance of government.

This is how modern liberalism was born; modern liberalism advocates positive role of the state in safeguarding and promoting the freedom of the individual. T.H. Green advocated a positive role of the state in the establishment of schools, hospitals, creation of jobs, and labour rights etc. Modern liberalism believes in the virtues of a free market, but it would want to modify and regulate the free market economic system. This became the difference between the modern liberals and the classical liberals: the later continue to believe that complete freedom to the market will produce growth and prosperity, and eventually a social equilibrium. As compared, modern liberals argue that the operation of the market needs to be supplemented and corrected. It calls for a balance between market and state. Modern liberals advocate the idea of welfare state; and believe that material progress would lead to the establishment of a humane world.

John Stuart Mill in the 19th century and John Rawls in the 20th subscribed to this brand of modern liberalism. A more recent offshoot of modern liberalism is what is called liberal egalitarianism: John Rawls emphasizes on equality alongside freedom. Liberal egalitarians argue that state should strive to bring about both equality and liberty. State may restrict liberty so as to promote greater equality in the society. Of course, liberal egalitarians too, like all modern liberals, advocate economic freedom which is necessary for the working of capitalism.

The above thus brings out the differences between 'classical' and modern liberalism. Their essential difference is on the role of the state and the equation between market and the state.

iii) *John Maynard Keynes*

John Maynard Keynes wrote in the period between the two world wars. He understood that 20th century societies were very complex in economic and social terms. The idea of an uncontrolled free market, as classical liberals had suggested, or the idea of a market economy but with state playing a positive role as advocated by modern liberals had proved insufficient. First World War had destroyed whatever had been attained over the past four

> centuries in terms of liberalization of trade and building of a financial and trade infrastructure in terms of norms and standardization. Keynes was also concerned with the Great Depression of 1929 which was unusually very deep and lasted very long. A liberal economist, he was concerned with labour unrest and the alternative socialist economic ideas that were coming from Soviet Union. Foremost, it was clear that some rational economic planning is required to streamline the working of capitalist market economy. It was the context in which the ideas of the liberal British economist, John Maynard Keynes gained wide acceptance among intellectual and policy making circles. In his *The General Theory of Employment, Interest, and Money* (1936), Keynes theorized that government management of the economy could smooth out the highs and lows of the business cycle, which is a principal characteristic of capitalist economy. State regulation and intervention is necessary to produce more or less consistent growth with minimal unemployment.

The influence of Keynesian ideas was widespread in liberal capitalist countries. In US, President Franklin D. Roosevelt (1933-39) launched the New Deal to lift the US economy out of Great Depression. New Deal made government expand its economic and social activities through economic regulations and welfare measures. Roosevelt administration took steps to create jobs, instituted social security and pension, and regulated the working of banks and industry.

After the Second World War ended in 1945, Western Europe, North America, and Japan entered a period of steady economic growth and prosperity. Liberal economists and policy makers now began to focus on institutional factors that would produce high economic growth in these countries. Inspired by Keynes, liberal leaders in the West used government's power to borrow, tax, and spend not merely to counter contractions of the business cycle but to encourage continual expansion of the economy. It was further said that welfare measures by the state diminish class conflict, strengthen consensus around democracy and counter the appeal of communism. Major social welfare programmes were introduced in Britain, Scandinavian countries, Canada and the US. By 1960s, the modern welfare state provided not only the usual forms of social insurance but also pensions, unemployment benefits, subsidized medical care, family allowances, and government-funded higher education.

Keynes' ideas had an equally profound effect on new institutions of global finance and trade that came to be established in the 1940s. Keynes believed that the international system that paved the way for the First World War could as well be transformed into a peaceful and just world order. From his work at the Paris Peace Conference in 1919, and throughout the rest of his life, Keynes played a role on the international stage. Some of his thoughts on international economic relations and global economy, to put briefly, were: (i) After the Paris Peace Conference of 1919, Keynes supported the right to self determination of the colonial and subjugated people. He believed that independence of nations from one another is necessary to achieve domestic economic goals. (ii) He prescribed national self sufficiency, even a degree of economic isolation to achieve goals of domestic economic development. (iii) He advocated two things: governments must generate full employment and maintain decent level of real wage. These two would eliminate economic causes of war and conflict. Such policies of governments though would produce inflation, sometimes in a perpetual manner, but this is an inevitable part of peace and development. (iv) Though he agreed that inflation is bad for a nation's currency. He accepted the idea of fixed exchange rates and restrictions on international capital flows so that countries could pursue independent economic policies. (v) He had observed that governments in the 1920s and 1930s were primarily concerned with their domestic economic issues, regardless of what happened at the international level. Keynes understood and even came to accept protectionism and isolationism in the 1930s. (vi) There was a lesson from the Second World War: matters of global governance should not be left unattended. Keynes was a firm believer in peace and benefits of civilization. He saw labour unrest and revolutionary ideas as twin threats to the liberal capitalist order. Again, these challenges could be checked through public policies of full employment and decent wages – so necessary to maintain global peace and stability.

Keynes, along with US Treasury official Harry Dexter White, is considered the intellectual founding father of the International Monetary Fund and the World Bank, which were created at Bretton Woods, New Hampshire. From 1936 to 1946, he worked for an international monetary system that would not pit interests of the countries against each other. Importantly, the global economy's institutional underpinnings – the IMF and the World Bank – have remained largely unchanged since his times.

3.3.2 Neoliberalism

Neoliberalism can neither be defined with any precision nor its historical lineage be articulated with some degree of certainty. Such is the confusion about the meaning and origin of neoliberalism. Proponents don't define it clearly; while critics highlight the negative dimensions of neoliberal economic policies – concentration of wealth, rise in inequality, domination of global and national corporate interests, international capital and multinational corporations penetrating across national borders and undermining state sovereignty. Neoliberals claim that their economic policy ideas are drawn from Adam Smith and David Ricardo. They invariably mention concepts like 'comparative advantage' and the 'invisible hand' that drives market.

The rise of neoliberalism in the 1970s marked an eclipse of the ideas of John Maynard Keynes who had advocated a role for the state in the creation of employment and redistribution of wealth. Neoliberals, like Milton Friedman, focus on monetarist theories which discount any significant role of the state. The idea that markets are self-regulating is central to the beliefs of neoliberals. Neoliberals say that efficient allocation of resources is the most important purpose of an economic system; and the most important way to allocate resources is through market mechanisms. State intervention distorts the logic of marketplace and thus the efficiency of resource of allocation. In other words, state intervention in economic affairs is most undesirable. It is believed that state intervention undermines the finely tuned logic of marketplace and thus reduces economic efficiency (Thorsen and Lie).

Neoliberalism has greatly changed the perception about economic development. International institutions like IMF, World Bank and the UN all have endorsed the neoliberal path of economic growth. Developed economies have championed it for long and pushed it in the developing countries through their policies of financial assistance and loans, trade concessions, lending policies of the multilateral financial institutions, and the working of private international banks and multinational corporations etc. The cumulatively approach and consensus among developed economies, multilateral organizations and private international banks is often referred to as the 'Washington Consensus' – a consensus that had been reached at in the 1970s on the prescribed path of neoliberal model as against Keynesian model of economic development or the socialist system. Today when one talks of 'reforms', it essentially means more economic and financial liberalization of a domestic economy through privatization, deregulation, tax cuts for the rich and eliminating labour and other rights and social welfare schemes. In nearly every country, public sector has been privatized and dismantled according to the logic of neoliberalism; also the assumption that market is the best allocator of resources has a great deal shaped international trade policies.

Some of the major assumptions and policy ideas associated with neoliberalism are: (i) the goal of human well being can be best served by unleashing man's entrepreneurial freedom and skills. (ii) For this, it is necessary to have an institutional framework that guarantees private property, free market and free trade. (iii) Neoliberals advocate role of the state. It is state which must build and guarantee the facilitating institutional setup. It should guarantee integrity of money, business contracts, international commercial and financial commitments, domestic stability and military defence for the smooth working of the market economy; and legal structures to guarantee security to the business sector. If markets do not exist or are weak, or are facing financial turbulence and economic slowdowns etc., state must intervene to create market, or strengthen existing market by infusing capital and through the so-called rescue packages. In simple words, neoliberalism advocates that state spend public money to save and serve private business in times of its need. (iv) State should get out of social sector – education, healthcare, social security. Create private suppliers of these goods. (v) Further it should create markets where none exist. This can and should be done through privatization. It should create private property where none exists. For example, state can create market in areas such as land and forests, water and irrigation, healthcare and education, social security and environmental pollution. Privatize all such areas; and let the consumers pay for everything they use. (vi) State should not venture beyond these economic functions. If it does, it will distort the working of the markets and thus mar the prospect of economic growth. Especially in a democracy there is this danger: a state could be leveraged to distort the working of the market. This may lead to the breeding of 'crony' capitalism and 'rentier; state. The simple adage is: markets know best. In conclusion, most essential for the state therefore is: once the market is created, state confine itself to the bare minimum. It is the night watchman of the classical economists. (vii) In brief, neoliberalism comes out as quite a distinctive economic theory which in recent times has replaced the Keynesian variety of modern liberalism. In fact, there is nothing liberal about neoliberalism. The ideology is far away from the ideals of individual liberty, democracy and human progress. Some of the worst authoritarian regimes of the 20th century practiced neoliberalism, e.g. Augusto Pinochet regime in Chile (1973-1989). Neoliberalism is more a set of political and economic practices centred around private economic forces.

Check Your Progress Exercise 2

Note: i) Use the space given below for your answer.

ii) See the end of the unit for tips for your answer.

1) Make a summary of the ideas of John Maynard Keynes.

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2) Delineate the ideology of neoliberalism.

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3.4 GLOBAL FINANCIAL ARCHITECTURE

The end of the Second World War is regarded as the watershed in the development of global economy. It saw the creation of a number of international institutions – political and economic – to uphold peace and security and promote monetary stability, financial support and a free and fair trading system. This is called the birth of Liberal International Order – formation of Bretton Woods institutions, the UN system and the General Agreement on Trade and Tariffs (GATT). The UN was established with the principal aim to ensure international peace and security through cooperation and collective security measures. The Bretton Woods Institutions (BWI) comprising the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) (the World Bank) were instituted for monetary and financial cooperation. While IMF, based in the US, aims at providing monetary assistance to economies, particularly during time of crisis; the IBRD, also based in the US, lends to governments in order to develop their economies.

A comparable International Trade Organization (ITO) could not materialize because of differences between the US and its European allies. In 1948, General Agreement on Tariffs and Trade (GATT) was established as an interim treaty to encourage and lay down the norms of a liberalized trading system.

3.4.1 International Monetary Fund (IMF)

The mandate of both the institutions is different. However, the IMF and World Bank collaborate regularly and at many levels to assist member countries and to work together on several initiatives. IMF was officially established on December 27, 1945, when the 29 participating countries at Bretton Woods signed its Articles of Agreement. It commenced its financial operations on 1st March 1947. Presently, the multilateral institution has 189 members.

The IMF was established to build a framework for international economic cooperation and avoid repetition of the competitive currency devaluations that contributed to the Great Depression of the 1930s. Its mandate and governance have evolved over time along with changes in the global economy, allowing the organization to retain a central role within the international financial architecture.

Objectives of the IMF: Primary objectives are: to promote exchange stability throughout the world; to promote international monetary cooperation; to facilitate the expansion and balanced growth of international trade; to assist in the establishment of a multilateral system of payments; and to make resources available to members experiencing balance of payments difficulties.

What is an IMF 'quota'?: Each member country is assigned a quota. Quota is basically money that a member country has to give to the IMF. The larger a country's quota, the more say that country has in the governance of the international financial institution. A country's quota at the IMF determines: its voting power; the amount of financial resources it must provide to the IMF; and the size of its access to the IMF financing.

How a quota is decided ?: The quota of a country depends on its economic importance. When a country joins the IMF, it is assigned an initial quota in the same range as the quotas of existing members that are broadly comparable in economic size and characteristics.

The size or amount of the quota a country is assigned is decided through a formula. The formula takes into account factors such as the size of the GDP, economic openness and international reserves a country has, etc. Suffice to say, the value of a quota indicates the overall impact a country has on world economy. Member countries pay their quota through a mix of foreign exchange or gold and in their own national currency.

Quotas are denominated in Special Drawing Rights (SDRs), which is an international reserve asset determined by the value of the US dollar, Euro, Japanese yen, Renminbi and pound sterling.

What purposes IMF Quotas serve?: IMF quotas serve multiple purposes: (i) Quota subscribed by a member indicates the funds it has provided to the IMF. Hence it constitutes the resource base of the IMF. (ii) A country's loan entitlement depends upon the size of its quota. In exceptional financial contingency, a country can access finance more than its entitlement. (iii) Size of quota determines voting power of a member. Decisions are taken based on weighted voting of members. (iv) India's quota share is about 2.76 per cent. It means its voting weight would be around the same percentage. US enjoy a voting power of 16.54 per cent. IMF rules state that all important decisions should be taken with at least 85 per cent of the votes. In reality, this would mean that no decision can be taken without US consent.

What does IMF quota reform entail?: Quota formula is subject to review. The last review was carried out in 2016. The reforms have increased the quota of each of the IMF's 189 members. Of course, the United States continues to retain the largest quota, with a share of 16.52 per cent in 2017. The quota reform has doubled the overall financial resource base of the IMF. Much of these added resources have come from the extra funding that many member countries contributed to the IMF after the global financial crisis of 2008. The quota reforms (i) boost the financial power of the IMF to respond in times of financial crisis; (ii) give emerging economies such as Brazil and China larger quota shares at the institution; (iii) the redistribution of quota shares means that China jumps from the sixth to the third largest member country, behind the United States and Japan. At 6.09 per cent, China's quota share increases by more than 2 percent. In 2017, India had a share of 2.64 percent, Russia 2.59 per cent and Brazil 2.22 per cent. (iv) while all member countries gain larger quotas, emerging market countries relatively gain more. The reforms shift about 6 per cent of quota shares to emerging market countries. As a result, quota share of traditionally strong economies such as the United States, Saudi Arabia and European countries slightly diminishes. But it doesn't affect much; quota reduction is less than half a per cent in most cases. The quota shares of the poorest member countries remain largely unchanged.

Reform of the global financial architecture was deemed necessary for long. IMF shareholders decided that the reforms were necessary in order to (i) more accurately reflect the growing global influence of emerging market economies; and (ii) to boost the IMF's legitimacy as a global financial institution. With more finances at its disposal, it is hoped that IMF will respond more effectively to financial crises and contribute strongly to the global financial stability.

The IMF governance structure is made up of the Board of Governors, Executive Board and Ministerial Committees. The Board of Governors is the highest decision-making body of the IMF. It consists of one governor and one alternate governor for each member country. The governor is appointed by the member country and is usually the minister of finance or the head of the central bank. The IMF's 24-member Executive Board conducts the daily business of the IMF and exercises the powers delegated to it by the Board of Governors, as well as those powers conferred on it by the Articles of Agreement. The 2016 reforms bring a change here: the selection process for executive directors on the IMF's board changes. Once the reforms are in place, all positions will be determined by election, rather than the present prevailing system where the member countries with the five largest quotas each appoint an executive director.

3.4.2 International Bank for Reconstruction and Development (IBRD) - (World Bank)

The IBRD along with the International Development Association (IDA) is called the World Bank organization The World Bank is a multilateral financial institution that provides loans for capital projects. Generally, every member country of the IMF becomes the member of the IBRD. When a country quits the IMF, it stands automatically expelled from the World Bank.

The mandate of the World Bank is to promote long-term economic development and alleviation of poverty by providing technical and financial support to help countries reform particular sectors or implement specific projects. Akin to IMF, the mandate and governance of World Bank have evolved along with changes in the global economy. The World Bank is composed of 189 member countries. These member countries, or shareholders, are represented by a Board of Governors, who are the ultimate policymakers at the World Bank. Generally, the governors are member countries' ministers of finance or ministers of development.

They meet once a year at the Annual Meetings of the Boards of Governors of the World Bank Group and the International Monetary Fund. The next level in the governance structure is the 25 Executive Directors, who work on-site at the Bank, and governors delegate specific duties to them. The five largest shareholders appoint an executive director, while other member countries are represented by elected executive directors. The World Bank Group President chairs meetings of the Board of Directors and is responsible for overall management of the Bank. The President is selected by the Board of Executive Directors for a five-year, renewable term. The Executive Directors make up the Board of Directors of the World Bank. They normally meet at least twice a week to oversee the Bank's business, including approval of loans and guarantees, new policies, the administrative budget, country assistance strategies and borrowing and financial decisions. The World Bank operates day-to-day under the leadership and direction of the President, management and senior staff, and the vice presidents in charge of Global Practices, Cross-Cutting Solutions Areas, regions, and functions.

Upon their establishment, the first task of the IMF and the World Bank was to attend to the restructuring of the world economy on account of the de-colonization process of many developing countries in the 1950s. The main task was the integration of these decolonized countries into the mainstream world economy. To address this situation, the two institutions expanded their realm and created two affiliated organisations of the World Bank. In 1956 the International Finance Cooperation (IFC) was established. Its purpose is to grant credits to private organisations that lack capital for projects in the developing world. In 1961 the International Development Association (IDA) was founded and its main function is to grant credits to especially poor countries at very favourable conditions.

In 1960s and 1970s enduring imbalances of payments between the Western industrialised countries resulted in the crisis of the international financial governance. The official termination of gold convertibility of the US dollar in 1971 was the immediate trigger of such crisis. This was intensified with the oil crisis of 1970s. Calls for a "new system of Bretton Woods" gained momentum in the 1980s and 1990s, particularly due to the restructuring of the world order in the wake of the end of Cold War and collapse of the Soviet Union.

During the 1997–1998 Asian crisis, there was almost worldwide consensus that the existing international financial architecture with the IMF at its core was not effective to resolve the crisis and help the crisis laden countries to manage and overcome the crisis. In fact, the IMF was alleged to have intensified the severity of the crisis. As a result, many Asian policymakers and observers questioned the credibility of the IMF. Efforts were underway to reform the international financial architecture which included the establishment of the Financial Stability Forum (FSF); the creation of a new Group of Twenty (G-20) process for finance ministers and central bank governors; improvements of information transparency and disclosure; the adoption of international standards and codes; stronger financial regulation through the Basel Committee on Banking Supervision and such others. However, such reform was not enough to prevent another crisis. The global financial crisis of 2008-09, which engulfed the developed countries, renewed the discussion on reforming the international financial architecture. As such, the FSF has been expanded to become the Financial Stability Board (FSB) with a greater mandate and a larger membership, and the IMF financial resources have been substantially augmented to assist countries affected by the global financial crisis. As the world economy recuperates slowly from the global financial crisis, the process of reforms of the Bretton Wood Institutions (BWI) continues to be tardy.

The dominance of the Western countries on the financial governance of the BWIs is well illustrated by the fact that despite the broadened membership on account of the emerging and developing economies in the global economy, the governance structure of both the IMF and the World Bank remains dominated by the advanced economies. Apart from the dominance in voting shares, the BWI since their inception have been headed by advanced economies. In light of this skewed representation, developing countries have been at the forefront in demanding reform of the Financial Architecture involving the BWI – the World Bank and the IMF. The main rationale driving such demands is the asymmetry in terms of representation and their failure in accommodating the increased economic influence in the global economy, especially of the emerging economies. The growing economic clout is evident from the fact that the share of the developing countries to global GDP has increased from 25% in 1960 to 56% in 2016, and the share of developed countries plummeting from 80% to 44% for the same period. More importantly, the share of the emerging economies like China, India and Brazil constitute 25% of the global economy. Although reforms were agreed in 2010 in terms of voting shares, it was finally implemented in 2016, particularly because of delay in approval by the US Congress.

Check Your Progress Exercise 3

Note: i) Use the space given below for your answer.

ii) See the end of the unit for tips for your answer.

1) What is the mandate of IMF? Describe the Quota system and SDRs of the IMF.

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2) Explain the organizational structure and working of the World Bank.

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3.5 LET US SUMP UP

Global economy can be described as the intertwined economic activity of various countries which can negatively or positively impact one another. Global economy can be best understood, not just as an economic activity, but as the intersection of economics with politics. State and other political dynamics shape issues of production and distribution. This interplay of economics and politics helps us understand and analyze the shape and the working of global economy. The relative influence of the state and market in defining global economy has been captured well by Robert Gilpin. He holds the view that state and other political forces shape decisions related to production and distribution and in particular "…political decisions and interests influence the location of economic activities and the distribution of costs and benefits of these activities."

The modern global economy came to be established and grew in the age of mercantilism (1500-1750) when trade grew within Europe and secondly, Europe also began trading on large scale and in a systematic manner with other continents. It was the 'age of discovery' and 'scientific revolution' which propelled both global trade and colonialism. Let it be understood that mercantilism gained strength under the aegis of strong national states and the development of a world market economy.

Mercantilism was based on certain beliefs and practices: gold and other precious metals were considered the indicator of a state's wealth. Exports more than imports make a nation wealthy. The political goal in mercantilist age was simple and straight: a powerful and wealthy state united under a glorious monarch. Under mercantilism, money became the medium to buy and sell. Large financial families and bureaucracy emerged to manage the global trade; so did national armies. "All of these factors ensured that the rising late medieval and early modern states embraced mercantilism as an economic theory that allowed them to adapt to and seek to exploit these shifting structures" (Source: "Europe, 1450 to 1789", *Encyclopedia of the Early Modern World*).

Mercantilist age came to an end with the outbreak of Industrial Revolution around 1780s. Industrial Revolution has a huge impact on all aspects of life. For instance, it led to an unprecedented increase in production and consumption, and thus in per capita wealth. Based on major industrial changes, society changed. Two new classes, viz. capitalists and working class emerged. A middle class also emerged; those who paid taxes were the first one to demand political representation. Scientific knowledge also expanded. In his seminal work *The Wealth of Nations*, Adam Smith concluded that industrialization increases the wealth for all. He thus debunked the two mercantilist beliefs: that there are limits to wealth; and that there are limits to which global trade could rise. In other words, creation of wealth and trade could have no upper limits. Adam Smith wrote in support of free market capitalism. He saw modern industries working on the basis of division of labour. He said that division of labour enabled factories to raised both production and productivity of their workers. He argued that people have a natural drive to improve their own lives. This self-interest propels markets to satisfy individual demands by producing goods and services. He called this the 'invisible hand'. The belief in the laissez faire was the at the core classical liberalism.

By the end of the 19th Century, there were many negative consequences of Industrial Revolution: economic inequality, poverty and ignorance. Most important however was the business cycle: capitalism was prone to boom-and-bust cycle. Faith in classical liberalism began to wane in the last decades of 19th century. It was proved by events that the principle of laissez faire was no magic wand. The belief that let the market operate freely was a myth. It was established that the way market economy works it would produce periodic bouts of stagnation.

The British political philosopher T. H. Green noted that things like income inequality and low wage prevent an individual from enjoying his freedom. Positive assistance of government is necessary to ensure these freedoms. Modern liberals argued that the operation of the market needed to be supplemented and corrected. They called for a balance between market and state.

First World War and the Great Depression were two major events in the early decades of the 20th century that interrupted the material and moral progress, modern liberals had advocated. Critics noted that capitalism goes through boom-and-bust cycles. Business cycle is the chief characteristic of market economy. But the Great Depression had proved unusually long and devastating. Widespread unemployment, labour and social unrest and spread of radical ideas like the Bolshevik revolution threatened both global economy and peace.

John Maynard Keynes theorized that government management of the economy could smooth out the highs and lows of the business cycle, which is a principal characteristic of capitalist economy. State regulation and intervention is necessary to produce more or less consistent growth with minimal unemployment and decent level of wages. The influence of Keynesian ideas was widespread in liberal capitalist countries. A liberal economist, his thoughts also had a profound impact in the creation of multilateral financial institutions viz the IMF and the World Bank.

The period from 1945 marked the emergence of the Liberal International Order – formation of Bretton Woods institutions, the UN system and the General Agreement on Trade and Tariffs (GATT). The Bretton Woods Institutions comprising the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) (the World Bank) were instituted for monetary and financial cooperation. The General Agreement on Trade and Tariffs (GATT), which began as a treaty, intended at establishing a regime to promote international trade and prevent governments from resorting to protectionist measures.

The decade of 1970s marked the rise of the age of neoliberalism. Neoliberalism is a distinctive ideology; though it shares some of the historical roots and some basic vocabulary with liberalism. The rise of neoliberalism marked an eclipse of the faith in the state. Neoliberals, like Milton Friedman, focus on monetarist theories which discount any significant role of the state. The idea that markets are self-regulating is central to the beliefs of neoliberals. Neoliberals say that efficient allocation of resources is the most important purpose of an economic system; and the most important way to allocate resources is through market mechanisms.

Neoliberalism has greatly changed the perception about economic development. International institutions like IMF, World Bank and the UN all have endorsed the neoliberal path of economic growth. Developed economies have championed it for long and pushed it in the developing countries through policies of aid and assistance, loan restructuring and market access etc. In brief, neoliberalism comes out as quite a distinctive economic theory which in recent times has replaced the Keynesian variety of modern liberalism. In fact, there is nothing liberal about neoliberalism. The ideology is far away from the ideals of individual liberty, democracy and human progress. Some of the worst authoritarian regimes of the 20th century practiced neoliberalism, e.g. Augusto Pinochet regime in Chile (1973-

1989). Neoliberalism is more a set of political and economic practices centred around private economic forces.

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3.7 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress Exercise 1

1) Your answer should include following:
   - Beliefs and practices of mercantilism
   - Economic, commercial, political and intellectual impact of the Industrial Revolution.

Check Your Progress Exercise 2

1) Your answer should include following:
   - The ideas of John Maynard Keynes and why and how he came to focus on the role of the state.
   - Delineate the ideology of neoliberalism and its belief in the efficacy of the market in resource allocation.

Check Your Progress Exercise 3

1) Your answer should include the following:
   - The mandate of the IMF, the working of the Quota system and SDRs.
   - The organizational structure and working of the World Bank.