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# THE STATE AND THE MARKET

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29 August 2021

EE443 Globalization and International Development

# Presentation outline

- 01** Views on economic growth
- 02** Post WW II experience and state role in development
- 03** What made the difference?
- 04** Development approaches
- 05** Conclusion



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# VIEWS ON ECONOMIC GROWTH

# Views on economic growth

- Adam Smith: economic progress is achieved by individuals who work through the market to specialize in the production of one particular product (invisible hand)
- David Ricardo:  $\text{Growth} = \text{Savings} + \text{Investment} + \text{Accumulation of capital}$
- Karl Marx: capital accumulation = central driving force of growth



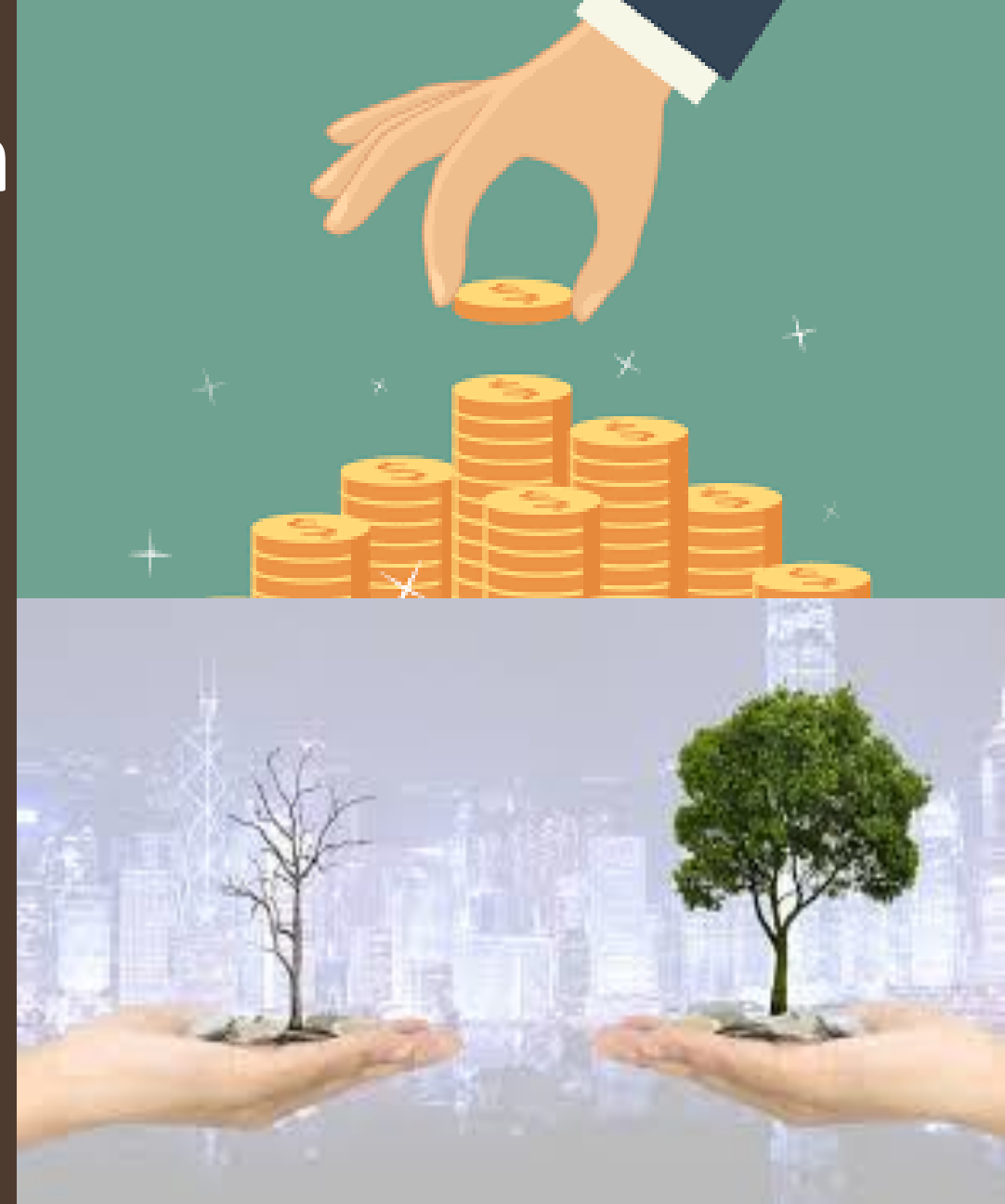
# Views on economic growth

- Roy Harrod and Evsey Domar: Growth = Investment + Capital
- Robert Solow: Growth = Factor accumulation + Innovation
- Hollis Chenery: Foreign exchange is needed for poor countries to grow in the absence of investment and savings



# Views on economic growth

- At the heart of the debate, the consensus is that:
- Capital, and investment are critical to economic growth
- Governments (state) and private firms (market) have roles to play in economic growth
- However to what extent do states and markets play in economic development?
- How can poor/developing countries acquire capital?





What is role of the **STATE**?  
What is the role of the **MARKET**?



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# POST WW II EXPERIENCE AND ROLE OF THE STATE

Design Option #5

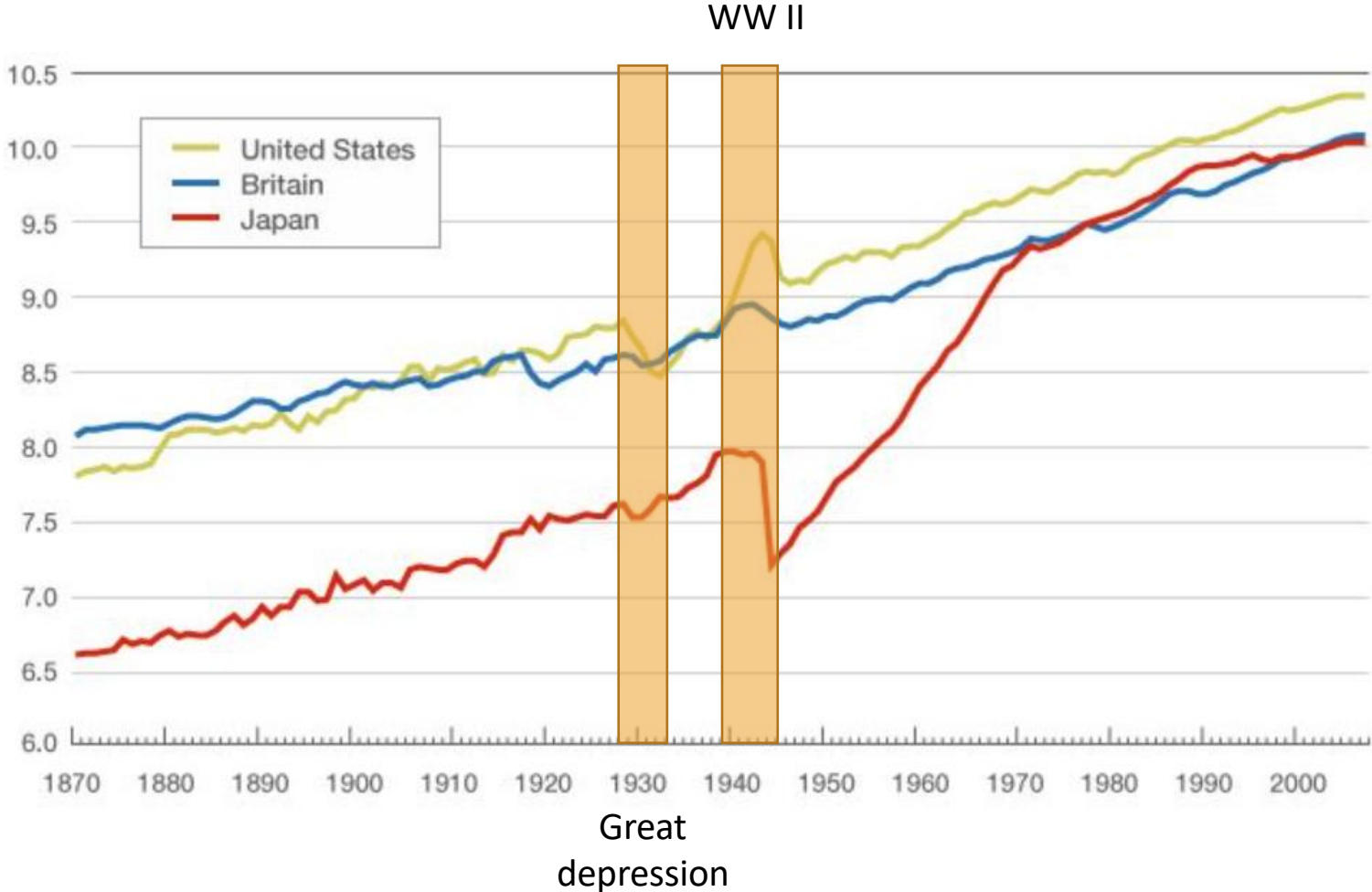
# Experience of Europe and Japan

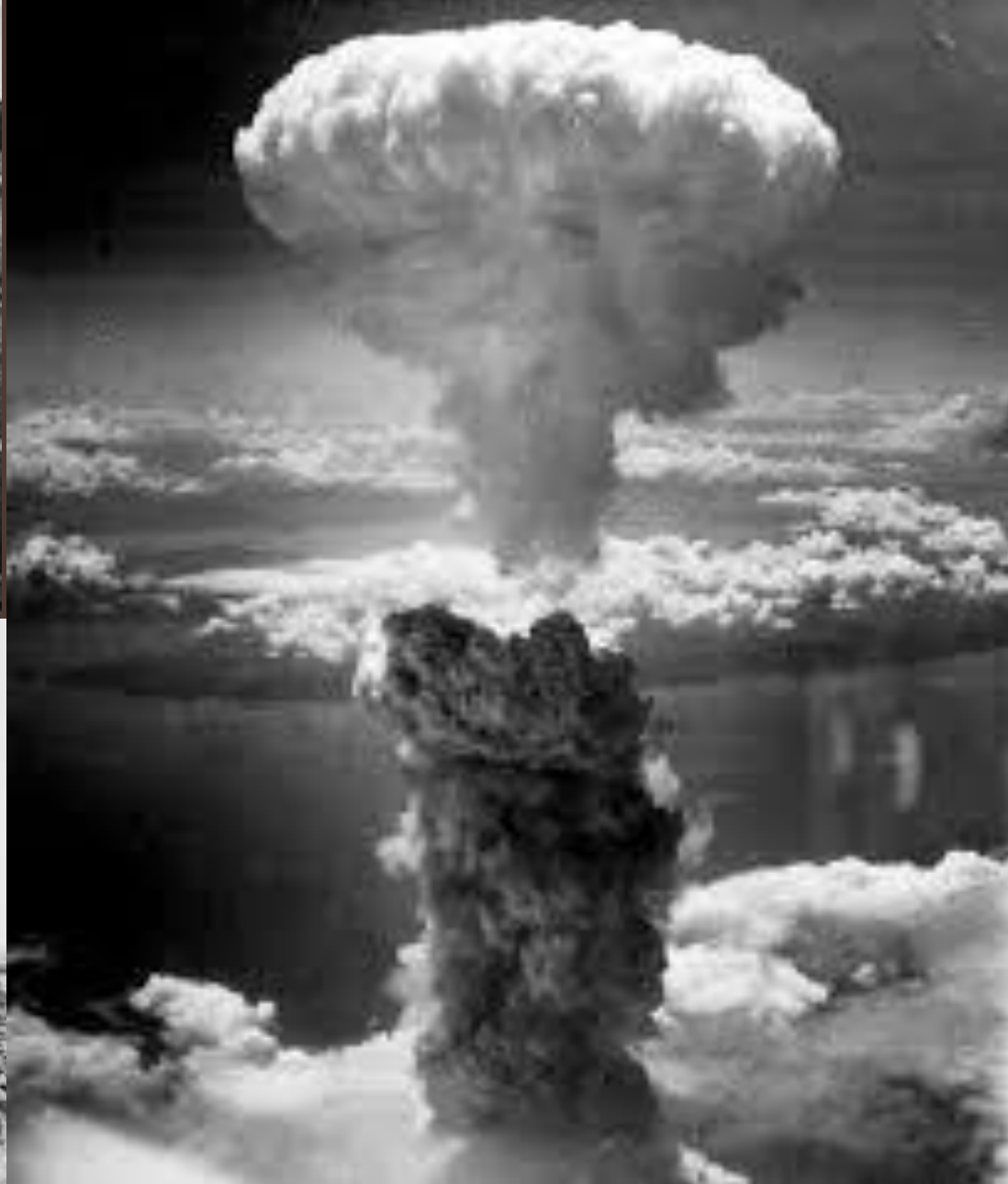
- Devastation in Europe and Japan following World War II
- \$25 billion aid to reconstruct Western European (Marshall Plan)
- \$7 billion aid to reconstruct Japan (Dodge Plan)
- Results were immediate and direct; high growth rates in Western Europe and Japan
- US provided aid to strengthen ties with Western Europe and Japan and to contain further the spread of communism



# GDP per capita, 1870-2000

GDP per capita figures for the US, UK and Japan, 1820-2000





**Clockwise from top left:**

Destruction of St. Paul's Cathedral, London; atomic bomb over Nagasaki; destruction of Hiroshima



Clockwise from top left: electric bulbs production line at Shibaura Electric company; women help clear rubbles, France; Germany rebuilds its infrastructure

# Experience of developing countries

- Difficulties encountered in starting modern industries in developing countries post World War II
- Initial response: provide capital (Hollis Chenery)
- Development has occurred slowly/not occurred despite flow of foreign aid
- Developing countries post World War II: had no market, no skills, no capital



# Development assistance



Rural water supply project, Cambodia



Humanitarian assistance, Ethiopia



Primary education, Indonesia



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Road construction, Vietnam



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Rural health, Philippines



Hydropower plant, Sri Lanka

# Experience of the Soviet Union

- The Soviet Union growth model based on central command seemed to be working
- Allocation of resources done by the state
- However the system was inefficient and became irrelevant after the collapse of the Soviet Union





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**WHAT MADE THE DIFFERENCE?**

# Western Europe and Japan

- Although Western Europe and Japan were devastated by the war, institutions, legal systems, and know-how were intact.
- Key institutions were embodied in people
- Key business decisions were by the private sector/market



# Developing countries and the Soviet Union

- Less developed countries were formerly under colonial rule, where capital was in the hands of colonialists), modern institutions
- Functioning markets did not exist; key decisions to allocate resources were taken by the government
- In the communist states, key decisions to allocate resources were taken by the state; emphasis was on heavy industry and agriculture production





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# DEVELOPMENT APPROACHES

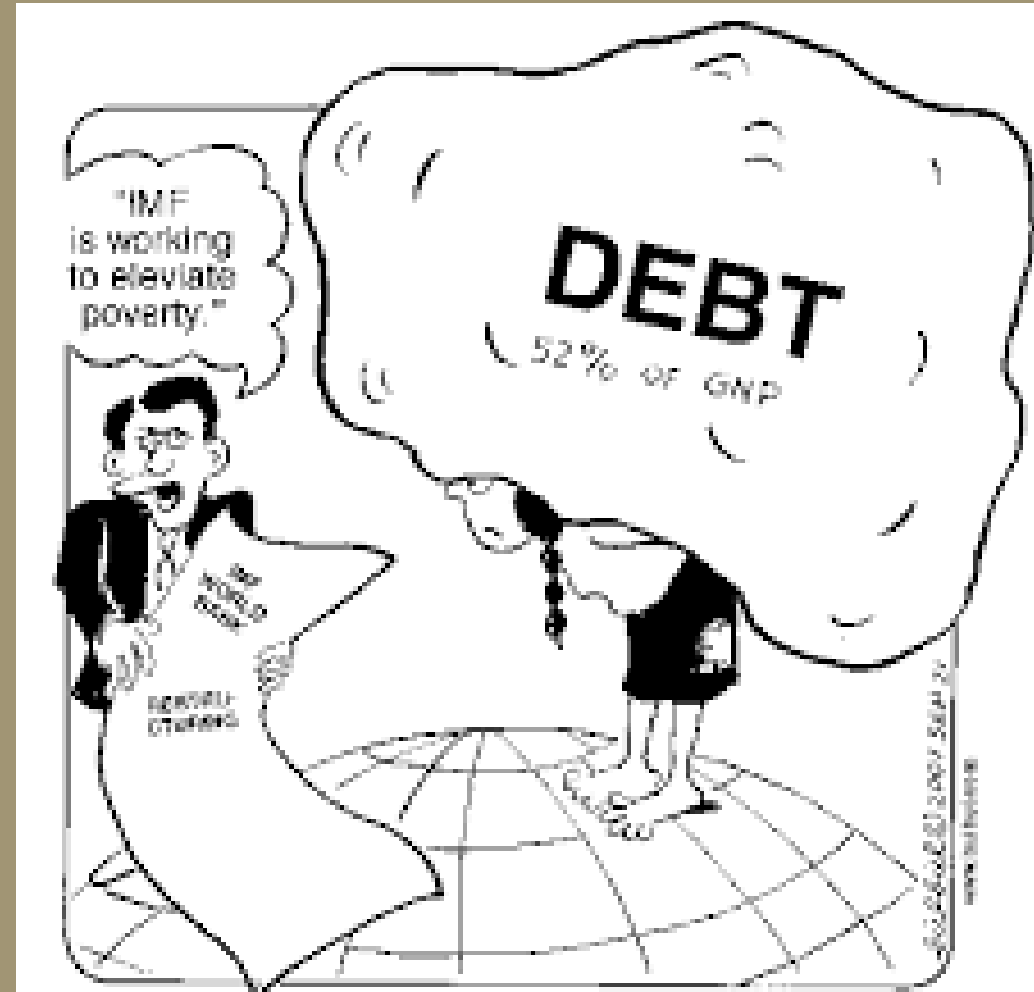
# State-led growth, 1950s-70s

- Developing country economies cannot be left to the market; government planning and intervention was needed to achieve economic growth
- The Soviet “central command” approach was preferred; governments prepared national economic development plans
- Developed countries provided foreign capital/assistance and assisted in designing and managing development projects



# Shift to market mechanisms, 1970s-80s

- Foreign aid to developing countries was not having the intended effect; too much aid, accumulated debt, too few results
- Too much effort to achieve economic growth, less focus on how benefits of growth are distributed; most development aid going to a few people
- Shift in thinking: too much government interference impedes growth: excessive bureaucracy, red tape, government protection, tariffs)



# Shift to market mechanisms, 1970s-80s

- Latin American countries began to pull out of the debt crisis
- The Soviet Union collapsed in 1989
- Eastern European countries were wresting power from the Soviet Union
- Baltic states under the Soviet Union became independent: Estonia, Latvia and Lithuania
- China, Viet Nam, Cambodia and Lao PDR embarked on economic reforms
- Modest reforms in India

## Transition to market based economies

Countries faced heavy debt burdens, inefficiencies, and hyperinflation, particularly in centrally-planned economies

# Lessons on economic transition

- Governments were able to curb hyperinflation and relax price controls
- Short-term drop in GDP and rise in unemployment
- Medium-term economic depression
- State-owned enterprises face difficulties competing a free market system because of subsidies and inefficiencies

## Main lesson:

Economic transition in the short term is not easy

However in the long term if fundamental changes are made countries' outputs will generally improve

Commitment and political will are important

# Structural adjustment, 1990s

- Poor performance of many developing countries and excessive government intervention is a detriment to development; therefore change is needed
- Reforms were made to restructure the economy to become more market-based, efficient, and open to international trade
- In 1990s, some countries were not able to repay their debts; World Bank made structural adjustment a conditionality to receive aid and loans

## What are structural adjustment measures?

- Eliminate subsidies for food, fuel and education
- Eliminate tariffs
- Limit wage increases
- Abolish price controls
- Restructure state-owned enterprises

# The 2000s and beyond

- Market-based reforms of the 1980s and 1990s had not addressed issues of equity
- Citizens of former Soviet Union states and Eastern Europe were not able to afford accommodation, food, and other basic necessities as subsidies disappeared
- With increased globalization, those who were not able to compete are marginalized
- Dissatisfaction with globalization therefore increased and backlash against globalization increased





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**CONCLUSION**

# Conclusion

- The role of the states and markets has been a central focus of debate since the time of Adam Smith and even more so following World War II
- Following World War II, focus was on accumulating capital as key to economic growth; which was evident in the reconstruction of Western Europe and Japan

# Conclusion

- The perceived success of the Soviet Union's central planning model and the difficulties of newly-independent countries to develop pointed to the need for expanded government role and rejected reliance on market forces
- Developing countries view that international trade benefits industrialized countries
- There was an increased emphasis on self-sufficiency in production, which gave rise to large state-owned enterprises

**T**HANK **Y**OU!