

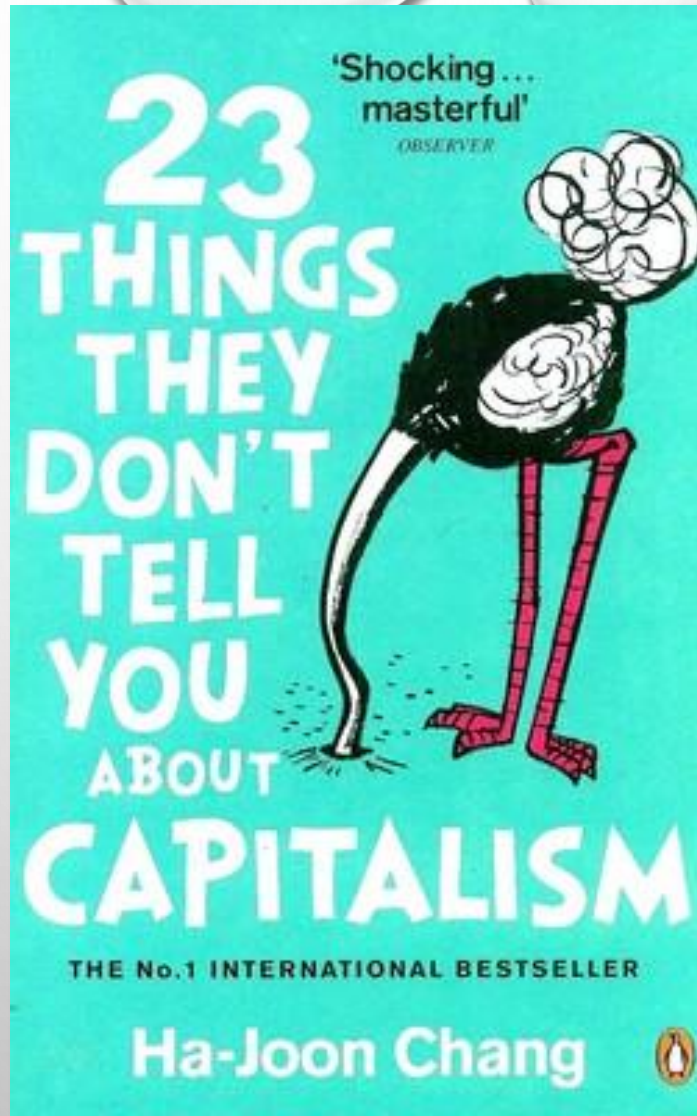


ECONOMISTS' QUESTIONS

- How do agents make a decision?
 - How do agents exchange/interact?
 - How does the economy/the world works?
- 

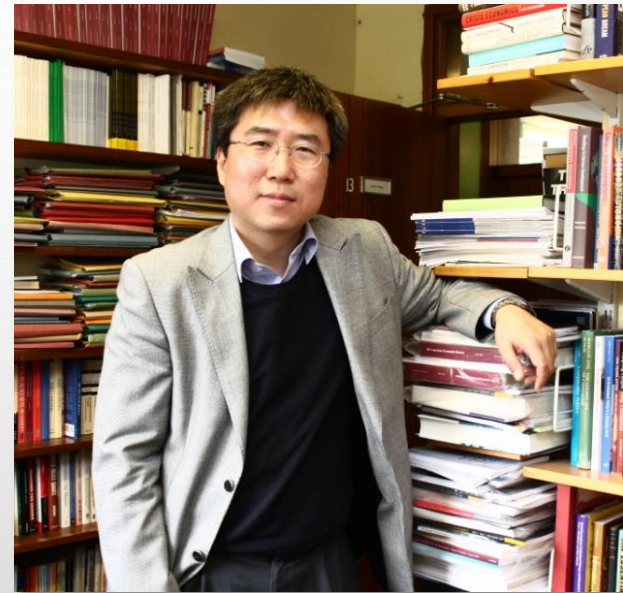
NEOCLASSIC BEHAVIORAL ASSUMPTIONS

1. The economic world is reasonably viewed as being in equilibrium.
2. Individual economic actors repeatedly face the same choice situations or a sequence of very similar choices.
3. the actors have stable preferences and thus evaluate the outcomes of individual choices according to stable criteria.
4. given repeated exposure, any individual actor could identify and would seize any available opportunity for improving outcomes and, in the case of business firms, would do so on the pain of being eliminated by competition.
5. Hence no equilibrium can arise in which individual actors fail to maximize their preferences.
6. Because the world is in approximate equilibrium, it exhibits at least approximately the patterns employed by the assumptions that the actors are maximizing.



23 THINGS THEY DON'T TELL YOU ABOUT CAPITALISM

- HA JOON-CHANG



FREE MARKET

We have been told that, if left alone, markets will produce the most efficient and just outcome

Efficient, because

- Individuals know best how to utilize the resources they command
- Firms, being closest to the market, know what is best for their businesses and should be given maximum freedom

Just, because the competitive market process ensures that individuals are rewarded according to their productivity



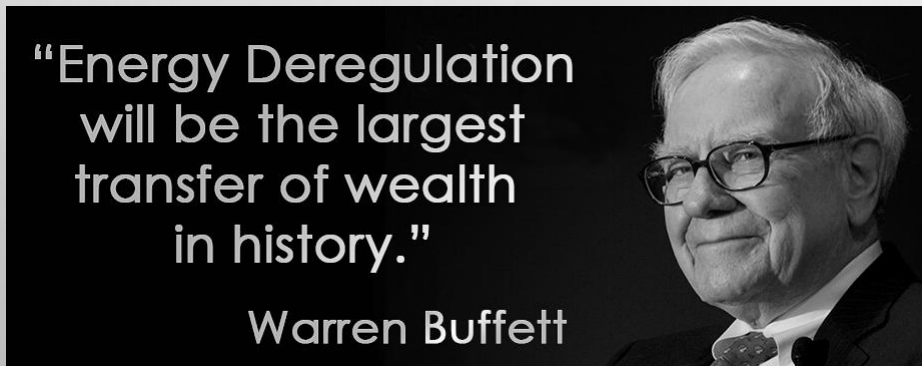
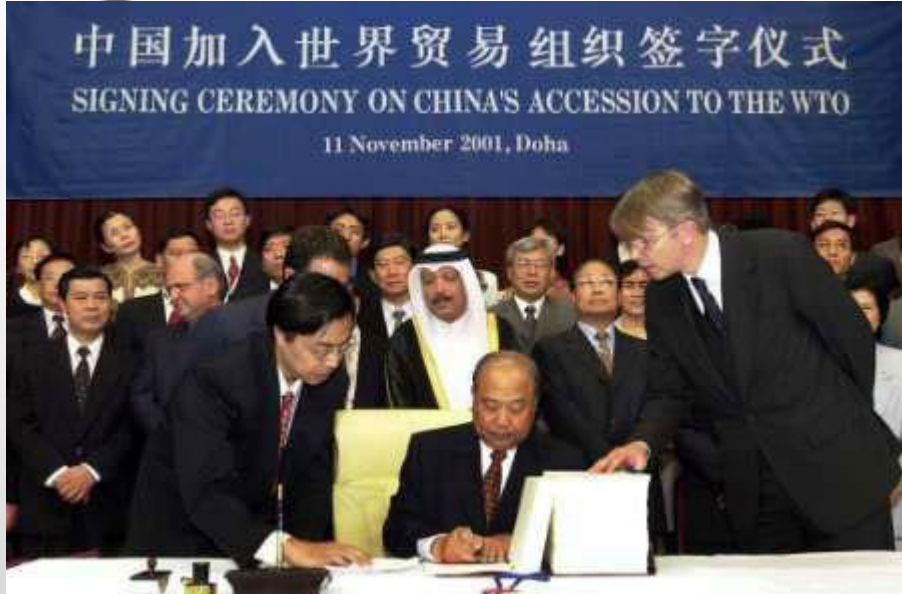
**The only fair
is laissez-faire.**

FREE-MARKET

- Governments cannot improve on market outcomes, as they have neither the necessary information nor the incentives to make good business decisions



FREE-MARKET



- Following this advice, most countries have introduced free-market policies over the last three decades –
 - **Privatization** of state-owned industrial and financial firms,
 - **Deregulation** of finance and industry
 - **Liberalization** of international trade and investment
 - **Reduction** in income taxes and welfare payments.

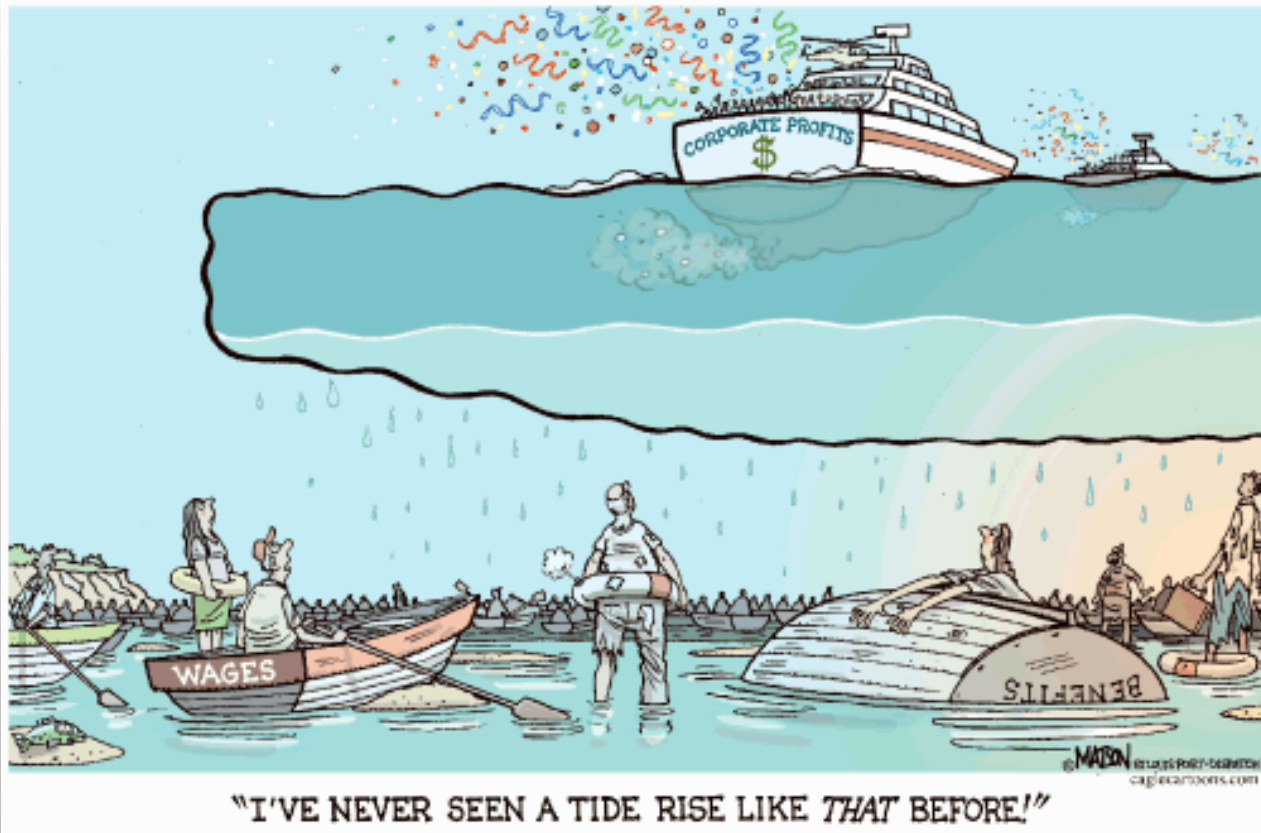
FREE-MARKET



- These policies may temporarily create some problems, such as rising **inequality**,
- but ultimately they will make everyone better off by creating a **more dynamic and wealthier society**
- **The rising tide lifts all boats together!**

FREE-MARKET

- The rising tide lifts all boats together!



BUT WHY??



- Slower growth, rising inequality and heightened instability in most countries
- Thus, what we were told by the free-marketeers – or, as they are often called, **neo-liberal economists** – was at best only partially true and at worst plain wrong!



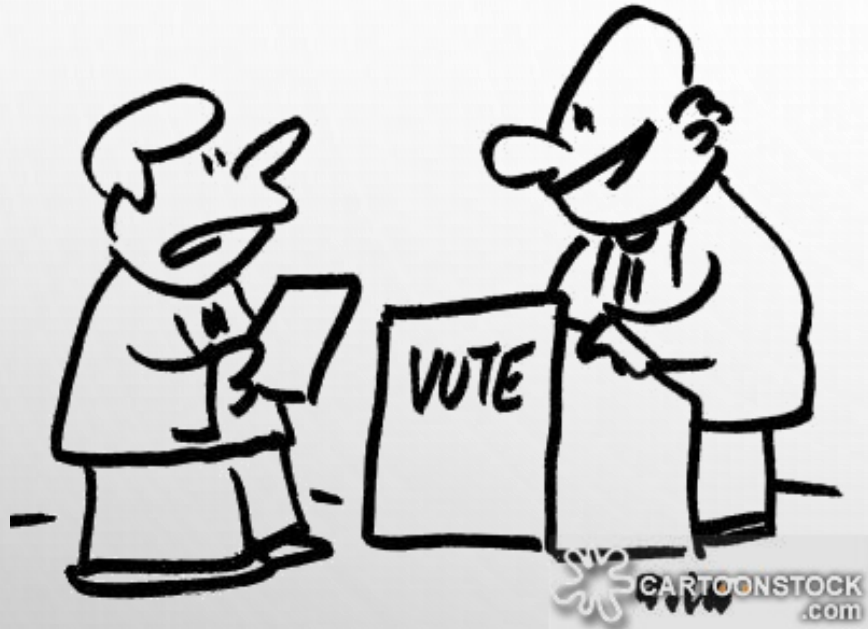
FREE-MARKET



- The 2008 global crash still remains the second-largest economic crisis in history, after the Great Depression
- The huge budget deficits created by the crisis will force governments to reduce public investments and welfare entitlements significantly, negatively affecting economic growth, poverty and social stability – possibly for decades
- This catastrophe has ultimately been created by the free-market ideology that has ruled the world since the 1980s.

THING 1

THERE IS NO SUCH THING AS A FREE MARKET



"Senator, I'd like to ask you about the economy."

"Talk to the invisible hand,"

- ***What they tell you:***

- Markets need to be free.
- People must be left 'free to choose'

- ***What they don't tell you***

- Every market has some rules and boundaries that restrict freedom of choice.
- Government is always involved

THING 1

THERE IS NO SUCH THING AS A FREE MARKET

- The 'freedom' of a market is, like beauty, in the eyes of the beholder.
- There is really no objective way to define how free that market is.
- If some markets *look* free, it is only because we so totally accept the regulations that are propping them up that they become invisible.



"Mirror, mirror, on the wall ... 'It's so subjective' is not an acceptable answer."

THING 1

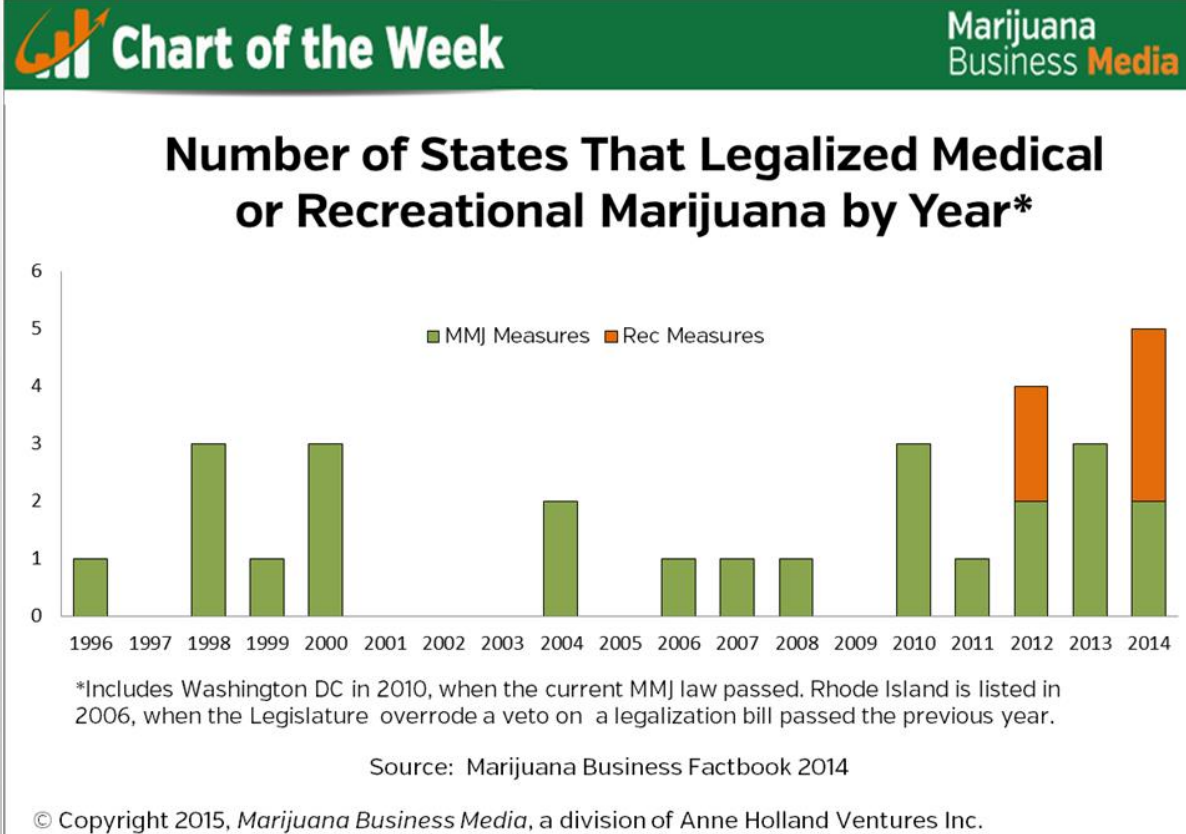
THERE IS NO SUCH THING AS A FREE MARKET



A Kungfu master & piano wire

THING 1

THERE IS NO SUCH THING AS A FREE MARKET



- Child labor?
- Ban trading in firearms or alcohol?
- Many countries allow only companies with more than a certain amount of capital to set up banks or enter stock markets.
- Restrictions on street-vending or zoning laws
- Interest rates are also determined by politics
- Fair trade?

WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]



What they tell you

- We should leave markets alone, because, essentially, market participants know what they are doing – that is, they are rational
- The government, to restrict the freedom of their actions, can only produce inferior results

What they don't tell you

- We have 'bounded rationality'.
- We are not that smart to leave the market alone.
- We need to, and usually do, deliberately restrict our freedom of choice in order to reduce the complexity of problems we have to face

WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]

- **'Bounded rationality'**: Herbert Simon (1916-2001)

■ Rational Model

- Decision-making by individuals is the outcome of logical, rational processes

■ Bounded Rationality

- Various factors conspire to undermine rational decision-making processes; in reality, people satisfy rather than optimise

■ Factors undermining rationality

- Lack of environmental surveillance
 - ◆ People tend to deal with problems that require immediate attention rather than focus on the future; people select the most obvious rather than the best alternatives
- Satisficing behaviour
 - ◆ People choose the solution that will do rather than is necessarily the best, i.e. don't look for optimal solutions

People, in many different situations, seek something that is "good enough", something that is satisfactory



WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]



*All the possible moves for
a move is around 10120*

- The world is too complex for our limited intelligence to understand fully.
- The main problem we face in making a good decision is not the lack of information but our limited capability to process that information.
- Individuals create routines in their daily lives or chess games

WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]



- Companies operate with 'productive routines', which simplify their options and search paths
- They build certain decision-making structures, formal rules and conventions that automatically restrict the range of possible avenues that they explore, even when the avenues thus excluded outright may have been more profitable.
- They still do it because otherwise they may drown in a sea of information and never make a decision



WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]



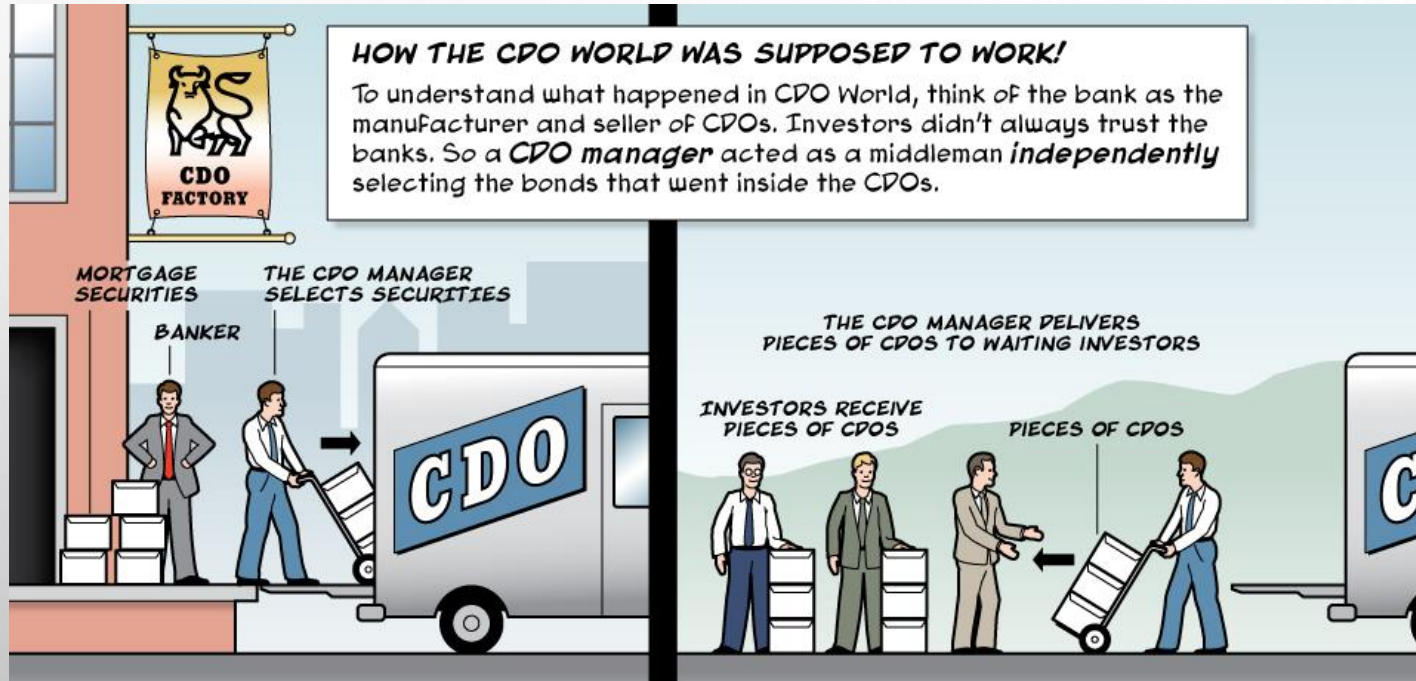
- Similarly, societies create **informal rules** that deliberately restrict people's freedom of choice so that they don't have to make fresh choices constantly.
 - a convention for queuing so that people do not have to constantly calculate and recalculate their positions at a crowded bus stop in order to ensure that they get on the next bus



WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]

- Free-market economists have argued against government regulation on the (apparently reasonable) ground that the government does not know better than those whose actions are regulated by it
- Simon's theory shows that many regulations work.
- *Not* because the government necessarily knows better than the regulated but because they limit the complexity of the activities, which enables the regulated to make better decisions

WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]



- **Financial Crisis 2008** - Our ability to make good decisions was simply overwhelmed because things were allowed to evolve in too complex a manner through financial innovation.
- So many complex financial instruments were created that even financial experts themselves did not fully understand them, unless they specialized in them
- Nor could the regulatory authorities fully figure out what was going on

WE ARE NOT SMART ENOUGH TO LEAVE THINGS TO THE MARKET [THING 16]

FEARS OF UNSOLD SECURITIES PILING UP AT THE BANK!

With fewer investors to buy pieces of CDOs, bankers feared certain securities could begin to pile up at the investment bank, losing value, in effect *rotting* at the bank's Factory.

INVESTORS
DISAPPEAR!

?

CDO

ROTTING
SECURITIES

?

CDO
FACTORY

- To avoid similar financial crises in the future, we need to restrict severely freedom of action in the financial market.
- Financial instruments need to be banned unless we fully understand their workings and their effects on the rest of the financial sector
- This is what we do all the time with other products – drugs, cars, electrical products, and many others

Wall Street giants like Citigroup and Merrill Lynch have been severely shaken by their losses on an arcane innovation in finance: collateralized debt obligations, or C.D.O.'s.

Worldwide, there is more than \$1.3 trillion invested in C.D.O.'s. Residential mortgage-backed securities, or R.M.B.S., make up 56 percent of the assets in C.D.O.'s. So the slump in housing has had a huge ripple effect on these investments.

<http://upstart.bizjournals.com/multimedia/interactives/2007/12/cdo.html>

DESPITE THE FALL OF COMMUNISM, WE ARE STILL LIVING IN PLANNED ECONOMIES [THING 19]

What they tell you

- In complex modern economies, planning is neither possible nor desirable
- Only decentralized decisions through the market mechanism, based on individuals and firms being always on the lookout for a profitable opportunity, are capable of sustaining a complex modern economy.

What they don't tell you

- Governments in capitalist economies practice planning too, albeit on a more limited basis than under communist central planning.
- Many capitalist governments plan the future shape of individual industrial sectors through sectoral industrial policy or even that of the national economy through ***indicative planning*** by mobilizing various carrots (e.g., subsidies, granting of monopoly rights) and sticks (e.g., regulations, influence through state-owned banks) at its disposal

DESPITE THE FALL OF COMMUNISM, WE ARE STILL LIVING IN PLANNED ECONOMIES [THING 19]



- The European and East Asian countries which practiced indicative planning all also practiced active sectoral industrial policy
- The share of State-owned Enterprises (SOES) in national output could be as high as 20 per cent-plus, in the case of Singapore, or as low as 1 per cent, in the case of the US, but the international average is around 10 per cent.
- Between the 1950s and the 1980s, the share of government funding in total R&D in the supposedly free-market US accounted for, depending on the year, between 47 per cent and 65 per cent, as against around 20 per cent in Japan and Korea and less than 40 per cent in several European countries



DESPITE THE FALL OF COMMUNISM, WE ARE STILL LIVING IN PLANNED ECONOMIES [THING 19]

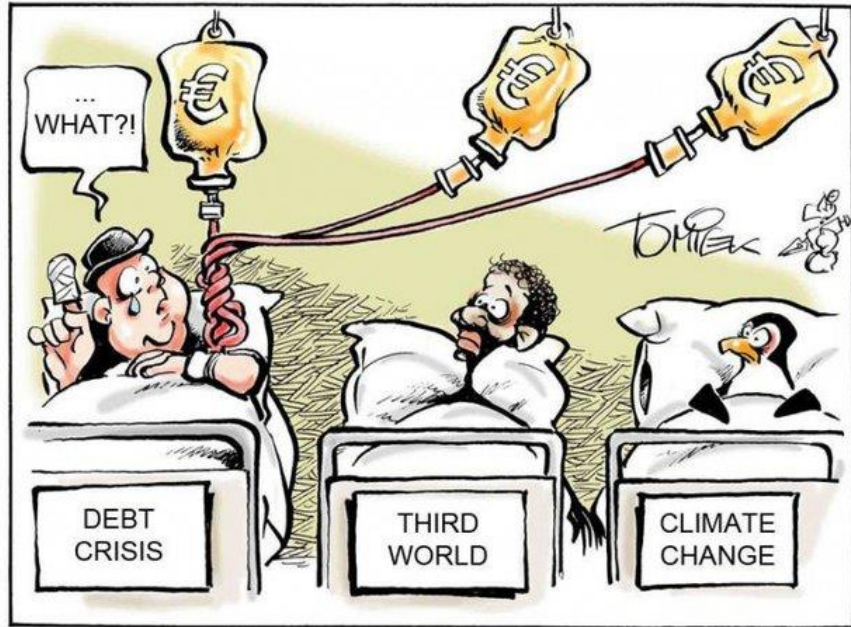


- Suppose that a new CEO arrived in a company and said: 'I am a great believer in market forces. In this fast-changing world, we should not have a fixed strategy and should maintain maximum possible flexibility.'
- So, from now on, everyone in this company is going to be guided by ever-changing market prices, and not by some rigid plan.'
- What do you think would happen?
- The question is not whether you plan or not. It is about planning the right things at the right levels.

GOVERNMENTS CAN PICK WINNERS [THING 12]

- The theory tells us that capitalism works best when people are allowed to take care of their own businesses without any government interference.
- Many of the businesses in Korea promoted by the government turned out to be great successes.
- In the 1960s, the LG group, the electronics giant, was banned by the government from entering its desired textile industry and was forced to enter the electric cable industry. The cable company became the foundation of its electronics business, for which LG is currently world-famous.
- In the 1970s, the Korean government put enormous pressure on Mr. Chung Ju-Yung, the legendary founder of the Hyundai Group, famous for his risk appetite, to start a shipbuilding company. Today, the Hyundai shipbuilding company is one of the biggest shipbuilders in the world.

GOVERNMENTS CAN PICK WINNERS [THING 12]



HOSPITAL

FUNNY CARTOONS ON KULFOTO.COM

- Governments are also likely to pick losers.
- Government decision-makers – politicians and bureaucrats – are driven by the desire to maximize power, rather than profits.
- Therefore, they are bound to go for white elephant projects that have high visibility and political symbolism, regardless of their economic feasibility.
- Moreover, since government officials **play with 'other people's money'**, they do not really have to worry about the economic viability of the project that they are promoting

GOVERNMENTS CAN PICK WINNERS [THING 12]



- Concorde project, jointly financed by the British and the French governments in the 1960s
- Concorde certainly remains one of the most impressive feats of engineering in human history.
- However, considering all the money spent on its development and the subsidies that the two governments had to give to British Airways and Air France even to buy the aircrafts, Concorde was a resounding business failure.
- The Indonesian aircraft industry was started in the 1970s, when the country was one of the poorest in the world. This decision was made only because Dr. Bacharuddin Habibie, number two to President Suharto for over twenty years (and the country's president for just over a year, after his fall), happened to be an aerospace engineer who had trained and worked in Germany.

GOVERNMENTS CAN PICK WINNERS [THING 12]

- Dominant economic theory fails to recognize that there could be a clash between business interests and national interests.
- The reality is that winners are being picked all the time both by the government and by the private sector, but the most successful ones tend to be done in joint efforts between the two.
- The success stories do not allow us to support governments picking winners under all circumstances
- The failures, however many there are, do not invalidate all government attempts to pick winners.
- The question is not then whether governments can pick winners, as they obviously can, but how to improve their 'batting average'
- If we remain blinded by the free-market ideology that tells us only winner-picking by the private sector can succeed, we will end up ignoring a huge range of possibilities for economic development through public leadership or public-private joint efforts.

FREE-MARKET POLICIES RARELY MAKE POOR COUNTRIES RICH [THING 7]

What they tell you

- All of today's rich countries, with the exception of Japan (and possibly Korea, although there is debate on that), have become rich through free-market policies, especially through free trade with the rest of the world.
- Developing countries that have more fully embraced such policies have done better in the recent period.

What they don't tell you

- Virtually all of today's rich countries used protectionism and subsidies to promote their infant industries.
- Developing countries did not do badly at all during the 'bad old days' of protectionism and state intervention in the 1960s and 70s.

FREE-MARKET POLICIES RARELY MAKE POOR COUNTRIES RICH [THING 7]

WHAT COUNTRY IS THIS? :

- The industrial tariff rate was at 40–55 per cent. The country's trade policy has literally been the most protectionist in the world for the last few decades.
- In the banking sector, foreigners are prohibited from becoming directors while foreign shareholders cannot even exercise their voting rights unless they are resident in the country.
- It does not have a competition law, permitting cartels and other forms of monopoly to grow unchecked.

WHAT IS GOOD FOR GENERAL MOTORS IS NOT NECESSARILY GOOD FOR THE UNITED STATES [THING 18]

What they tell you

- At the heart of the capitalist system is the corporate sector; this is where things are produced, jobs created and new technologies invented
- What is good for business, therefore, is good for the national economy
- Government needs to give the maximum degree of freedom to business

What they don't tell you

- Regulation can help firms by preventing them from undermining the basis of their long-term sustainability.

MARKET FAILURE



WHAT IS GOOD FOR GENERAL MOTORS IS NOT NECESSARILY GOOD FOR THE UNITED STATES [THING 18]



- Sometimes regulations help business by limiting the ability of firms to engage in activities that bring them greater profits in the short run but ultimately destroy the common resource that all business firms need.
- For example, regulating the intensity of fish farming may reduce the profits of individual fish farms but help the fish-farming industry as a whole by preserving the quality of water that all the fish farms have to use.
- A widespread use of child labor will lower the quality of the labor force in the longer run by stunting the physical and mental development of children. In such a case, child labor regulation can actually benefit the entire business sector in the long run.
- What matters is not the quantity but the *quality* of business regulation

ASSIGNMENT

- WATCH A MOVIE: **THANK YOU FOR SMOKING (2005)**
- DISCUSS: How the film represent the idea of **free market** and **market restriction**

