

STATES AND MARKETS

EE 462 Development Macroeconomics

Semester 1/2014

Topics

- Role of Markets and States in Development
- Development Thinking after WWII
- Fundamental Changes in the 1970s and 1980s
- Structural Adjustment
- The Washington Consensus

I. Roles of States and Markets

- Question: Who actually makes economic development happens?
 - Individuals interacting via markets?
 - Government?
- What should be the balance between markets and states?
- In this lecture, we will look at the **role of state** in achieving economic development from the past experiences of different countries around the world.
- But we need to know why government is needed in economic development in the first place.
 - What's wrong with markets?

Arguments for Markets

- Markets lead to **efficient allocation** of resources.
 - Under competitive economy, economic welfare is maximized.
- Market system is **more flexible** and able to adjust to business cycles than government control.
- Markets **promote competition**.
 - Motivates consumers and producers who are guided by self-interests.
- Reliance on markets disperses economic and political power and therefore is consistent with **democracy**.

Market Failures

- Markets under *certain conditions* provide the “invisible hand” to the economy.
- However, markets can fail due to the followings:
 - Monopoly or oligopoly control.
 - Presence of public goods and externalities
 - Change in economic structure, such as infant industry at early stages
 - Missing or underdeveloped institutions rules/laws
 - Macroeconomic imbalances
- Market failures provide justifications for governments to intervene.

II. Development Thinking after WWII

- The center of economic growth is **capital**.
 - Examples: Karl Marx, Harrod-Domar model
- The key to economic development was **for rich countries to provide aid**.
 - Example: Marshall Plan- injected \$25billion to rebuild western Europe
- Missing piece: the **role of supporting institution** required for economic development
 - Western Europe had fully developed legal systems and capable education systems.
 - These critical institutions were missing in “developing poor” and underdeveloped countries.

The “Big Push”

- Paul **Rosenstein-Rodan**:
 - Difficult for one modern industry to start up in a developing country, so need to develop a wide range of industries all at the same time.
 - Need a **government plan** to guide individual producers and to guarantee the demand
- Counter-argument: **Hirschman’s backward linkage**
 - Countries should emphasize industries with **strong linkages**, so that the creation of one industry would create demand for another industry’s production.

Other Ideas after WWII

- The **Soviet Union model** of growth
 - Emphasized the role of capital and high rates of investment
 - Gave priority to heavy industry
 - Allocation of goods were centrally planned by large government bureaucracies (limited role of markets)
- Reliance on trade to achieve economic growth
 - **Import substituting industrialization**
 - Production of goods and services that replace (or substitute for) imports
 - High protective barriers
 - Examples: South American countries

III. Fundamental Changes in the 1970s and 1980s

- Stylized facts:
 - By 1970s, many African countries experienced little or no growth.
 - In Latin American, import substitution industrialization did not lead to economic growth.
 - In the 1980s, a **debt crisis** in Latin American occurred due to large loans borrowed from abroad and the OPEC oil shocks.
 - Rise of **the Four East Asian Tigers** (South Korea, Taiwan, Hong Kong, and Singapore) in the 1970s → **Export-Led Growth**
- The role of government has become questionable. What went wrong? → **“government failures”**

The Four East Asian Tigers: The Role of States

- *South Korea and Taiwan*
 - Government were involved in **export promotion** and in **industrial development** (e.g. devalued currency, subsidized exports, temporary protection against imports, etc.)
 - Later on, these interventions were eliminated.
- *Hong Kong*
 - **Laissez faire** market
 - Government's role was to maintain a stable macroeconomic environment, support health and education
- *Singapore*
 - Government support particular industries and some key corporations
 - Focused on creating a **favorable environment for FDI**

III. Structural Adjustment

- Structural adjustment

- Includes reforms aimed at changing the structure of the economy to be more market based, more efficient, and more open to international trade
- Most of SAPs were ad-hoc and based on country-by-country approach
- Main objective was to reduce or remove distortions generated by government intervention
- Often faced political resistance
 - Example: Removing fuel or food subsidization

Structural Adjustment Program (SAP) by the World Bank

- Trade reform- opening the economy to trade
- Adjusting prices: “Getting prices right”
- Promoting market competition
- Fostering privatization
- Creating market support institutions
 - Legal system, financial system, well define property rights rules that promote long term investment and productivity.

IV. The Washington Consensus

- This is a comprehensive view of what successful development involved (developed from SAPs over time).
- Williamson labeled this reform agenda of growing agreement among Washington institutions (US Government, World Bank, IMF, other key international actors).
 - To identify “the **lowest common denominator**” of policy advice prevailing at the time
- There are 10 components of these consensus.

The Ten Components of the Washington Consensus

1. **Fiscal discipline:** Balance budget, deficit 1-2%
2. **Reordering public expenditure priorities:** Reduce subsidies including Military expenditure
3. **Tax reform:** Reduce taxes, improve incentives
4. **Liberalization of interest rates:** Real interest rate should be positive
5. **Competitive exchange rates:** Avoid currency controls, aimed at expanding exports
6. **Trade liberalization:** Reduce or eliminate tariffs (export and import taxes)

The Ten Components of the Washington Consensus (cont'd)

7. **Liberalization of Foreign Direct Investment (FDI):** Attract inflow of capital, skills and knowledge
8. **Privatization:** State enterprises should be privatized since they are more efficient under private ownership than state.
9. **Deregulation:** Reduce government regulations including entry and exit of firms. Also ensure safety of the environment.
10. **Secure property rights:** Provide long term property rights that is secure and transferable.

Soviet Command Model to Market Economies

- The Soviet Union and several Eastern European countries followed the Washington Consensus, but the results were disappointing (large drop in GDP and rise in unemployment).
- Recall the story of Viktor and Yulia from Ukraine in chapter 1
- What has gone wrong?
 - Change in the context (most products were no longer needed)
 - Radical transformation: privatization is the first step to change manager's behavior, but acquiring knowledge and skills take time.
 - Lack of institution needed for well functioning market

Transitions in China, Vietnam, and India

- These countries follow only some components of the Washington Consensus.
- **China**
 - Began opening up to foreign trade and FDI in late 1970s
 - Reform in agricultural sector to be based on the market forces
 - But slow changes for large enterprises
- **Vietnam**
 - Followed China's reform path
- **India**
 - Modest reforms by reducing regulation and freeing up markets
 - still maintain high degree of regulation on industry sector

Was Washington Consensus A Success or A Failure?

- Mixed evidence:
 - Some success stories in Latin America.
 - China and Vietnam did not privatize most of their SOEs.
 - The Four East Asian Tigers retained import restrictions during the first phase of industrialization process.
- So, what is the appropriate level of government intervention?
 - It depends!
 - **Hard government**: can intervene actively to promote growth
 - **Soft government**: unable to intervene efficiently
- Market-oriented reforms need to be done gradually.