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# STATES AND MARKETS

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EE443 Globalization and International Development

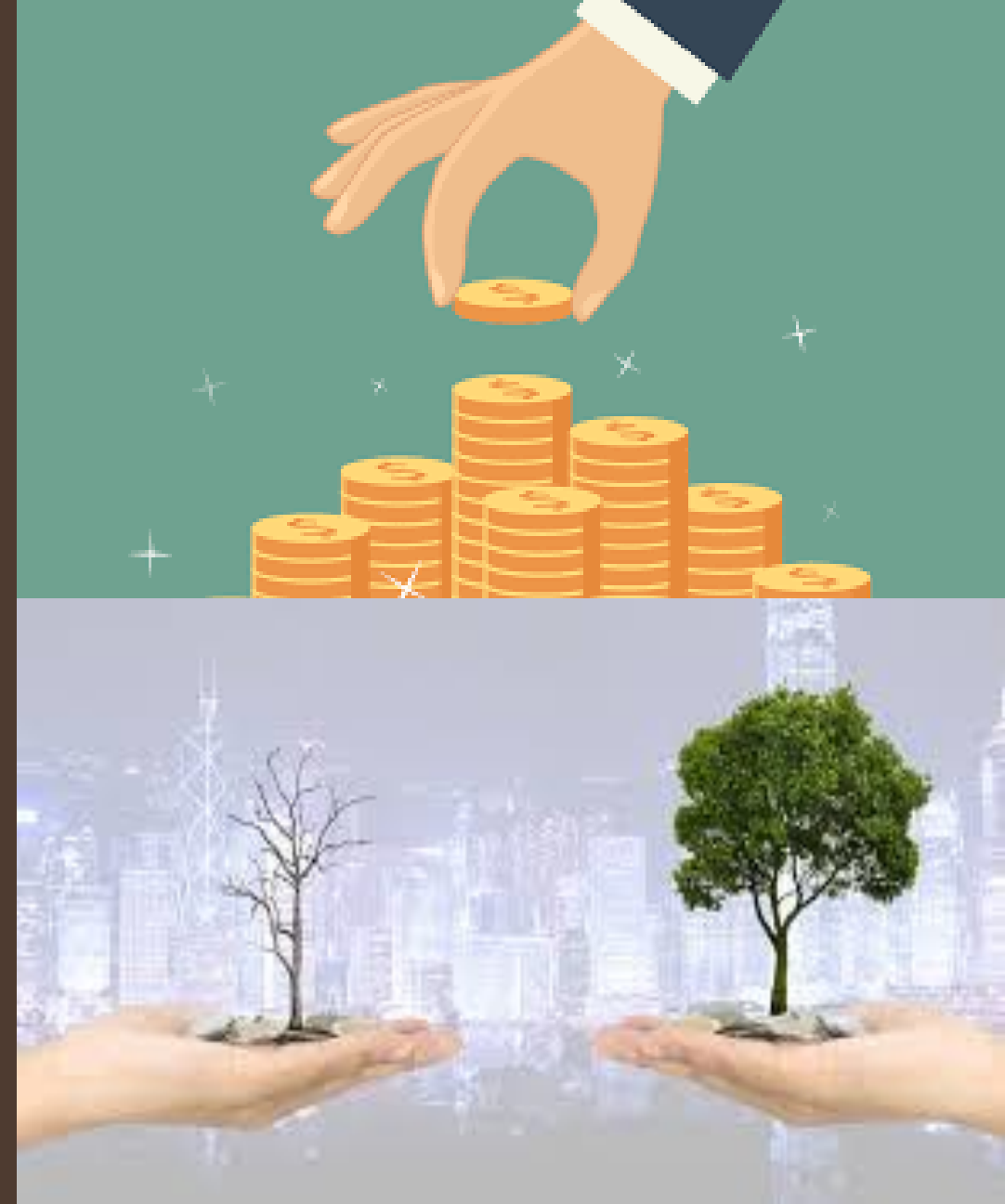
# Views on economic growth

- Adam Smith: economic progress is through market specialization (invisible hand)
- David Ricardo: Growth = Savings + Investment + Accumulation of capital
- Karl Marx: capital accumulation = central driving force of growth
- Roy Harrod and Evsey Domar: Growth = Investment + Capital
- Robert Solow: Growth = Factor accumulation + Innovation
- Hollis Chenery: Poor countries need forex in the absence of investment and saving



# Converging viewpoints

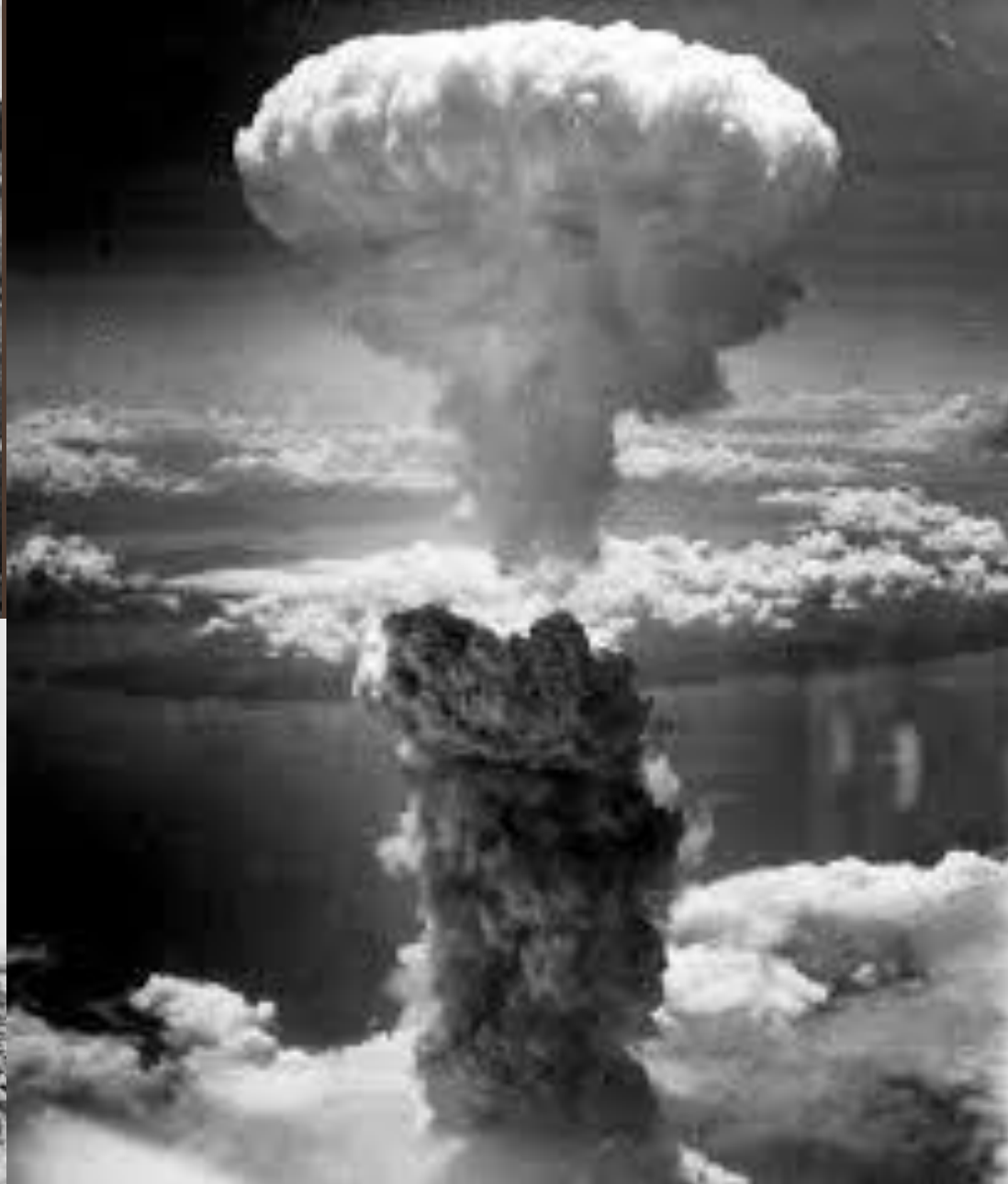
- Capital and investment are critical to economic growth
- Governments (state) and private firms (market) have roles to play in economic development
- What is the appropriate role of states and markets in economic development?



# Experience of Post WWII Europe and Japan

- Devastation in Europe and Japan
- \$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
- To strengthen ties with Western Europe and Japan and to contain spread of communism





**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 in starting modern industries in developing countries
- Initial response: provide capital (Hollis Chenery)
- Little development progress despite flow of foreign aid
- Reasons: 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

- Central command Soviet Union growth model 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

- Institutions, legal systems, and know-how were intact
- Key institutions were embodied in people
- Key business decisions by the private sector



# Developing countries and the Soviet Union

- Less developed countries: inherited colonialism, where capital was in the hands of colonialists
- No functioning markets; government decides on allocating resources
- Communists: resource allocation by the state; emphasis on heavy industry and agriculture production





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# DEVELOPMENT APPROACHES

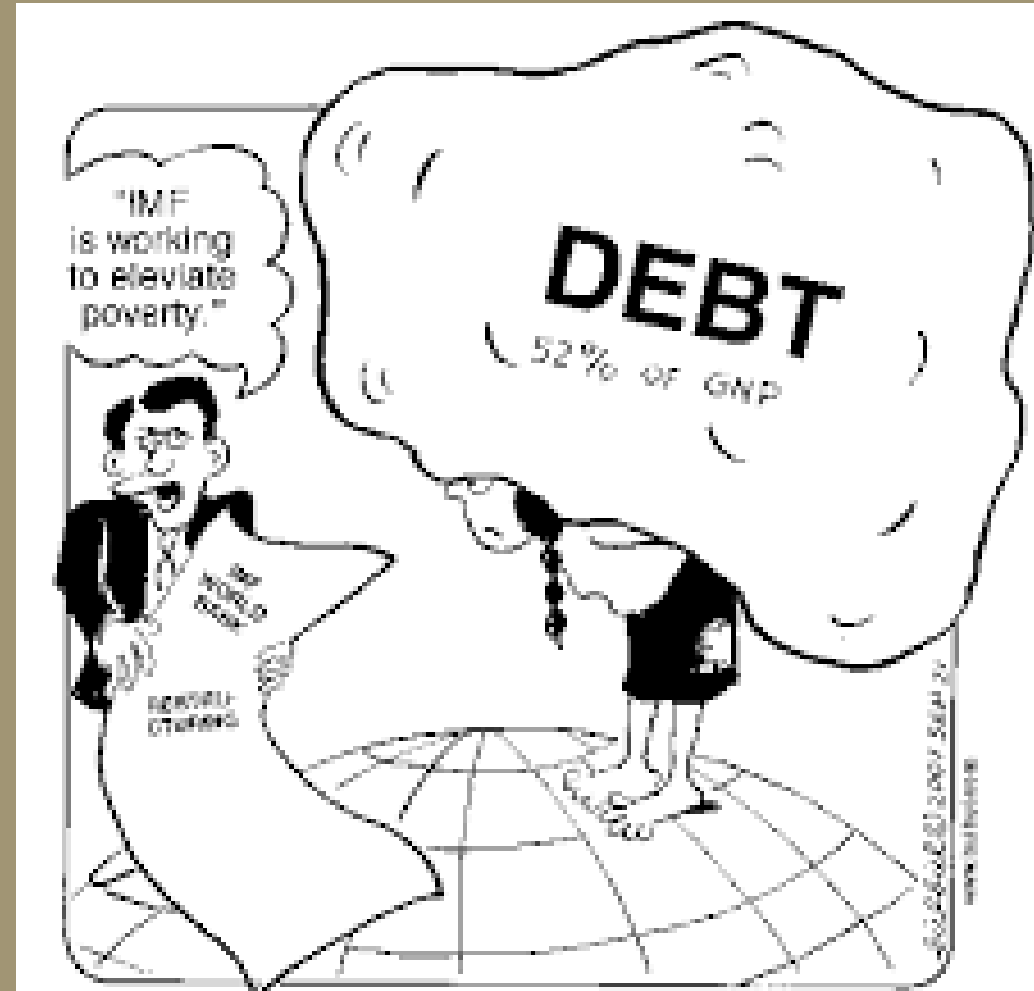
# State-led growth, 1950s-70s

- Government intervention to achieve economic growth
- The Soviet “central command” approach was preferred; governments prepared national economic development plans
- Developed countries provided foreign capital and assisted in designing and managing development projects



# Shift to market mechanisms, 1970s-80s

- Foreign aid to developing countries became ineffective; too much debt and few results
- Emphasis on economic growth, not on how benefits of growth are distributed
- Shift in thinking: government interference impedes growth, therefore bureaucracy should be minimized



# 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 broke away from the Soviet Union
- Baltic states became independent: Estonia, Latvia and Lithuania
- China, Viet Nam, Cambodia and Lao PDR embarked on economic reforms
- Modest reforms in India
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## 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 economic performance and excessive government intervention: a detriment to development; therefore change is needed
- Reforms 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
- Globalization marginalized those unable to compete
- Dissatisfaction with globalization increased and caused backlash



# 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
- 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

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