Lecture 7

Guiding Development: Markets versus Controls

(Based on Chapter 5 of Perkins et al.)

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Socialism

- Socialism.
  - Government ownership.
  - Prices of both outputs and inputs fixed by the government.
  - Central planners decide output targets.
  - Resource allocation decided by on basis of these targets.

Market Economy

- Characteristics.
  - Prices adjust to clear markets.
  - Allocation of resources based on demand and supply.

- Market failures.
  - Market concentration on account of scale economies.
  - Externalities.
  - Trade barriers.
  - Institutional failure.
  - Adjustment problems.
  - Ideologies and principles.

Mixed Economy

- Government controls in market economies.
  - Exchange rate management in Japan and China.
  - Subsidisation of agriculture in EU, USA and Japan.
  - Credit market intervention in China and India.
  - Income redistribution in EU and the USA.

Historical Perspective …. 1

- Loss of faith in capitalism.
  - Great Depression of the 1930s.
  - Theoretical underpinning of government intervention in Keynes’s work.
  - Rapid growth in Soviet Union.

- Loss of faith in “Soviet” socialism.
  - Stagnation of Soviet Union and other socialist countries during the 1960s and 1970s.
  - Rapid growth in capitalist USA and EU.
  - China’s success after starting to liberalise in 1978.

Historical Perspective …. 2

- Closing the circle …. Loss of faith in “American” capitalism?
  - Corporate bankruptcies, and associated corruption.
  - Burst stock market bubble.
  - “Fat cat” pay.
  - Pensions crisis.
  - Incompatibility of low tax rate and good public services.

Historical Perspective …. 3

- Or irreversible change? …. Further loss of faith in controls?
  - Failure of industrial policies in South Korea and Japan.
  - Accession of China to WTO.
  - Liberalisation and higher growth of the Indian economy.

A Compromise

- Coexistence of markets and regulations.
  - Control versus regulate.

- Credit market.
  - Banks allowed to set interest rates for deposits and loans.
  - Banks allowed to decide whether or not they will lend to an individual or a company.
  - Banks allowed to decide whether or not they will operate in a country or region.

- Regulation of banks.
  - Banks have to have a prescribed minimum amount of capital.
  - Banks must write off bad loans continually.
  - Banks must submit their financial records to FSA or other authorities regularly.

Elimination of Controls

- Free entry and exit from product and factor markets.
  - Creative destruction.
    - Allocation of resources.
    - Factor productivity.
  - Corruption.
  - Production compatible with comparative advantage.
    - Allocation of resources.

Implementing Market Reforms

- Stabilisation of prices.
  - E.g., post-liberalisation Russia and other transition economies.
- Existence of markets.
  - E.g., land market in transition economies.
- Competition.
  - Productivity growth.
- Incentives for firms' management to react to market signals.
  - Ownership.