Lecture 8

Guiding Development: Markets versus Controls

(Based on Chapter 5 of Perkins et al.)

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Recap

- Economic systems.
- Historical perspective.
- Elimination of controls.
- Implementation of market reforms.

Macroeconomic Stabilisation

- Bulgaria in 1996.
  - Bank runs because of lack of structural reforms.
  - Large fiscal deficit and stock of public debt.
  - Monetisation seen as inevitable.
  - Run of currency and hyperinflation.

- IMF programme.
  - Reduction of budget deficits.
  - Control growth of money supply.
    - <u>Controversy</u>: IMF role after East Asian crisis of 1997.
  - Devaluation of exchange rates.
    - Marshall-Lerner condition.
  - Removal of price controls.
  - Restraining wage increases.

Competition

- Measures.
  - Removal of barriers to entry.
    - What about barriers to exit?
  - Elimination or reduction of tariffs and quotas.
- Example.
  - Indian banking sector.
    - Removal of barriers to entry.
    - Removal of controls on interest rates.
    - Removal of controls on banks’ portfolios.
    - Uniform regulations for all banks.
      - Improvement in profitability and cost efficiency of domestic banks, including state owned banks.

Responding to Market Signals

- Private ownership.
  - Public choice theory.
  - Property rights theory.
  - Incomplete contracts theory.

- Agency problem.
  - Management versus owners.
  - Large shareholders versus small shareholders.

Transition from Controls to Markets

- Shock Therapy.
  - Russia.
    - Hyperinflation.
    - Absence of markets and institutions.
      - Corruption.
    - Emergence of oligarchy.

- Gradualism.
  - China.
    - Growth without inflation.
    - Stability attracting foreign investment.
    - Continuation of unprofitable enterprises, especially in the public sector.

Market failure …. 1

- Some labourers have no wealth.
  - Dependence on labour power.

- Labour power zero until some minimum nutrition level, positive thereafter.
  - Reservation wage higher than those labourers who have non-labour source of income.
  - Low productivity at current level of nutrition.
    - Low productivity per unit of wage.

- Employers care about productivity per unit of wage.
  - Many of the wealth-less labourers remain unemployed.
    - Vicious circle of poverty.

Market Failure …. 2

- Some borrowers in the credit market “peaches” while others are “lemons”.
- Banks know the distribution of peaches and lemons, but not who is a peach and who is a lemon.
- The average risk associated with a bank loan increases because of the presence of lemons.
- Raising interest rates to obtain the appropriate risk premium may lead to adverse selection.
- Banks may limit lending or stop lending altogether.
  - Bulgaria.
  - India.