

State vs Market

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COMMANDING THE BATTLE FOR THE WORLD ECONOMY HEIGHTS

The world around us

- We have embraced capitalism.
- Governments are selling off previously nationalised companies. MNCs are everywhere.
- Increasingly connected in a global economy.
- Privatisation, Deregulation, Liberalisation.
- Information technology is further boosting this transformation.
- New prospects and new opportunities opening up everywhere.

Microsoft



accenture



ORACLE

Infosys

Google



NOKIA
Connecting People

**Mentor
Graphics**

HSBC



Deloitte

POLARIS
live your dream



Honeywell

DELL



**Mc
Graw**



CORDYS

The world around us

- But there is also discomfort.
- People fear government will no longer be there to protect them.
- People are often uncomfortable about the price that market demands of its participants.
- People question the danger and legitimacy of markets.

The State

vs.

Free Market

Role of State

- What is the responsibility of the State in the economy?
- What is the preserve of private decision making?
- The frontiers are not well defined—constantly shifting.

Key factor

- Prices are at the very heart of what makes a functioning economy work.
- Should it be determined by govt. or left to the market forces of demand and supply?
- *"You can think of them as traffic signals. And if you don't have them, what you get is a system that doesn't work, or you get chaos". Ludwig von Mises*



Change of guard

- A 100 year arc has taken us from the last great era of international commerce to the one we know today.
- The fundamental relationship between the market and the state is getting altered.
- Everywhere the objective is to move away from government control and toward competition in market place.
- The scope of the Govt and its range of duties is steadily declining.
- This marks a great divide between 20th and 21st centuries.



Keynes vs. Hayek

- Whether the economy is based upon market-determined prices or on state planning: **heart of economic and political battles of last 100 years.**
- **John Maynard Keynes:** Market economy would go into excesses, wouldn't work in difficult times, and government would have to step in.
- **Friedrich Hayek:** The market would eventually take care of itself.
- For decades till 1980s, ideas of Keynes dominated economies of the Western World.
- Hayek's ideas began to prevail only from 1990s onward.

1st age of globalisation

- Start of the 20th century: **First age of globalisation.**
1850s-1920s.
- Technologies like telegraph and telephone revolutionised communications.
- Steamships and railways made the world a smaller place.
- Millions migrated without the need for passports.
- A global market where trade flowed freely.

“The inhabitant of London could order by telephone, sipping his morning tea, the various products of the whole earth, and reasonably expect their early delivery upon his doorstep”- Keynes.

A black and white photograph of World War I soldiers in a trench. The soldiers are wearing Brodie helmets and heavy combat uniforms. They are positioned in a line, with some sitting on the ground and others standing. The background shows a steep, grassy embankment. The text "World War 1" is overlaid in large, white, bold letters across the center of the image.

World War 1

- **World War I:** destroyed 20 million lives.
- Germany, Russia, Austria vs UK, France, Italy, US.
- People became disillusioned, bitter—they were looking for something better in the aftermath of the war.
- Socialism, communism seemed to promise that better world in the defeated countries.
- Public ownership of means of production and centralised planning.



Post WWI: Russia

- Russian revolution overthrew the old order of capitalist dictatorship.
- **Vladimir Lenin** was the leader. He was inspired by the economic theories of Karl Marx.
- Trade, commerce, private property became criminal acts. End economic exploitation of man by man.
- Govt controlled wages and prices. State controlled the economy.
- *"The state, the government, would control the overall economy... the **commanding heights** of the economy"*-Lenin.
- Led to an economic disaster: Soviet Russia haunted by famine, hunger and death.
- After Lenin, **Joseph Stalin** took over. Communist Party planned every aspect of the economy.

Post WWI: Germany

- Germany was already bankrupt from the costs of the war.
- It then had to pay heavy reparation payments.
- The war payments were out of proportion to what the economy could really take.

"If we take the view that Germany must be kept impoverished and her children starved and crippled, vengeance, I dare predict, will not limp. Nothing can delay that final war that will destroy the civilization and progress of our generation"- Keynes.

3.

Vorkost

63.

Kartoffeln



Post WWI: Germany

- Defeated governments printed more money. Hyperinflation.
- People carried money on wheels because they had to pay billions of Reichmarks for a piece of bread.
- Shoes that cost 12 marks in 1913 sold for 32 trillion marks in 1923.
- In Hitler's favorite beer bar a glass of beer cost a billion marks.
- Hyperinflation wiped out the savings of the middle class.
- This was one of the reasons for the success of the Nazis, of Hitler. They got support from these people who lost their fortunes.

1929-1934

- 1920s was boom time in the US. American were buying lots of stock especially of new radio companies.
- **Oct 4, 1929:** stock market bubble burst. Start of the **Great Depression**.
- Half of the banks shut down, factories were shut down, millions of Americans lost jobs, stood on bread lines and in soup kitchens.

FREE
SUP COFFEE & DOUGHNUTS
FOR THE UNEMPLOYED







Great Depression: Response

- Democracy was losing ground. World economy was collapsing.
- US President, **Franklin Roosevelt** feared the market system had failed.
- He created a series of new agencies to regulated banks, stock market, capitalism itself.
- Industry was subject to host of new rules and regulations.

1936: General Theory

- Keynes published “**General Theory of Employment, Interest and Money**”.
- His solution to unemployment was for the Govt to spend money to restore economic activity.
- In good times Govts should cut back spending and build surpluses and in bad times they should step up spending, run deficits and increase people’s purchasing power.
- His ideas took ground everywhere.



- It took a World War for Keynesianism to become government policy.
- US Govt borrowed money, pumped it into war effort, high unemployment ended and Depression disappeared.

"If expenditure on armaments really does cure unemployment, a grand experiment has begun. Good may come out of evil. We may learn a trick or two which will come in useful when the day of peace comes" - Keynes.

Keynes vs Hayek

- Hayek wrote "**The Road to Serfdom**" in 1944: Too much government planning means too much government power, and too much government power over the economy destroys freedom and makes men slaves.
 - Must let a competitive system work itself out. And if at times that meant there was considerable unemployment, well, that's what you had to put up with.
- *"In the long run we're all dead, and in the long run if we allow things to go on without remedy, we get lots of Hitlers, lots of wars, and lots of Stalins"*-Keynes.
- Most people would have agreed with Keynes when he wrote this to Hayek.
- In the battle of ideas, Hayek was on the losing side.

COLD WAR

- EASTERN BLOC
- WESTERN BLOC
- IRON CURTAIN



Post WWII

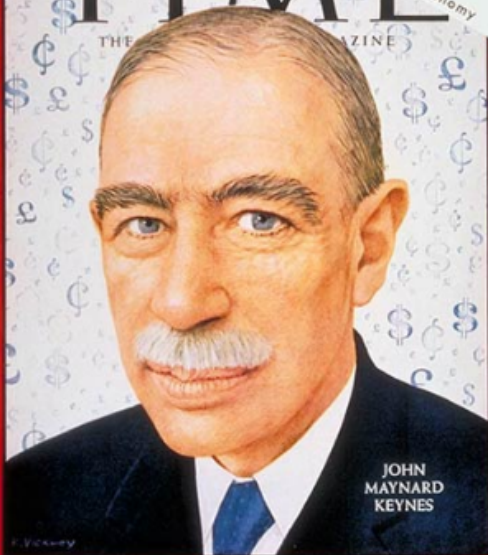
- *“At the end of World War II there was a tremendous loss of faith in the market economy”-Jeffrey Sachs.*
- The world was shadowed by the Iron Curtain, the Russian threat, by the failure to establish democracies in the Eastern European countries.
- Germany was in ruins. East Germany was controlled by Russia and in West Germany there was hyperinflation.
- Emerged with a combination of free market and strong welfare state.
- Throughout 1950s and 1960s: Govt control of economies continued. Regulation reigned supreme.
- Keynesian fiscal policies were used. Years of great economic growth.
- Keynes made the cover of Time magazine in 1965. Second deceased person to be so honored.

BUSINESS IN 1965:
The Keynesian Influence
On The Expansionist Economy

TIME

BUSINESS IN 1985
The Keynesian Influence
On The Expansionist Economy

THE MAGAZINE



Keynesianism

- Thirty glorious years (1950s- 1970s).
- Europe, Japan, America: high economic growth and rising standards of living.
- People enjoyed prosperity undreamed of at the end of WWII.
- Mixed economies as opposed to complete central planning.

1970s: Stagflation

- In early 1970s, middle eastern crisis led to oil crises.
- Inflation skyrocketed and growth was slowing down. Stagflation.
- After 30 glorious years of growth, the American economy was in trouble.
- Keynesian paradigm was not what it seemed to be.
- Unemployment rose and price rise could not be stopped.
- Taxes were too high, regulation was too tight.

1970s: Stagflation

- Stage was set for deregulation.
- Fundamental questioning of the model of *regulatory capitalism*.
- Too rigid, too slow, hobbled technological and commercial innovation.
- Conditions warranted change.
 - The specter of market failure had shaped 4 decades of govt economic policies (1940s to 1970s).
 - From late 1970s the message was: govt could fail too. Perhaps markets were not so dumb after all.

A New Age: 1980s

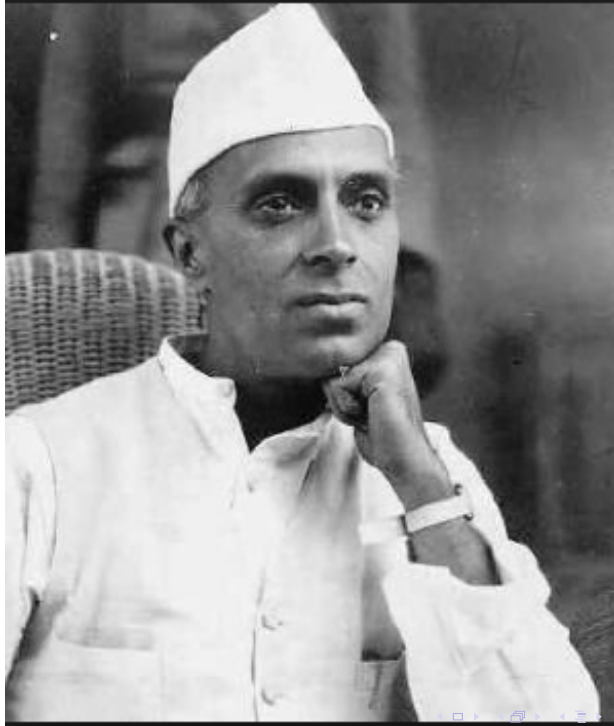
USA.

- USA: Control inflation.
- Deregulation.
- Modest tax rates.
- Limited government spending.

UK.

- Margaret Thatcher in UK: End nationalisation, control and regulation.





India: Nation building

- Nehru wanted to industrialise and combine British Parliamentary Democracy with Soviet-style central planning.
- World's largest democracy post independence.
- Advice from all economists: have a state-led model of industrial growth.
- Public sector must occupy the commanding heights of the economy.
- Steel, coal, - all areas of heavy industry were in public sector.
- Central planning. Mahalanobis's model.

India: Permit Raj

- India became the model of economic development for newly independent nations
- Across the developing world, socialism, planning, government control, regulation, and ownership – these became the gospel.
- Africa, South America.
- British Raj was replaced by Permit Raj.

India: Permit Raj

- Businessmen found it almost impossible to get things done.
- *"It used to take us about 12 to 24 months and about 50 visits to Delhi to get a license to import a computer worth \$1,500"-Narayan Murthy.*
- Since it was impossible to work with the system, people learned to work around it.
- Every license, every permit, was procured by corrupt means.

India: Import Substitution

- Self-sufficiency. To protect its own manufacturing industry, India shut out foreign imports.
- Because of this protected market, people were given shoddy goods and services at very high prices.
- Enterprise was stifled, and growth was crippled.
- Environment was not conducive to profitability.
- It was a shortage economy.

India: Control and Planning

- *"If you have a controlled economy, cut off from the rest of the world by infinite protection, nobody has any incentive to increase productivity, to bring new ideas"- Manmohan Singh*
- Private property was subordinated to the state in the building of the economy.
- A mixed economy emerged heavily weighed towards the state.
- Existing large private industrial empires of Tata and Birla families remained intact.
- Host of new public sector companies created-power utilities, chemical plants, automobiles, hotel chains, state owned banks.
- Development aid from World Bank and other international agencies.

विदेशी वक सरकारक नियम
मे अप्रभावित
आप सेवेमे लगी राष्ट्रीयकरणका



श्री मोरारजी देसाई का
इस्तीफा स्वीकृत

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14 TOP BANKS ARE NATIONALISED

Ordinance follows unanimous Cabinet decision

"The Times of India" News Service

NEW DELHI, July 10.

WITHIN an hour of the formal call of Mr. Morarji Deasai from the Union Government, the Cabinet today decided to nationalise 14 top commercial banks, thus providing an immediate answer to justification for the Prime Minister's political boldness taken during the week.

Nationalised banks

The 14 banks to be nationalised are: The Central Bank of India, The Commercial Bank of India, The Indian Bank, The Bank of India, The Bank of Commerce, The Bank of Calcutta, The Bank of Bengal, The Bank of Bihar, The Bank of Bombay, The Bank of Madras, The Bank of Mysore, The Bank of North India, The Bank of Punjab, and The Bank of Sudan.

The nationalisation of these banks will be effected by an ordinance, which will be introduced in the House of Commons today.

The Prime Minister, Mr. Deasai, who resigned on July 10, stated that the Government had decided to nationalise these banks as a first step towards the complete nationalisation of the banking system in India.

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Kamraj, Chavan happy

"The Times of India" News Service

NEW DELHI, July 10.

Mr. Kamraj Chavan, Minister for Industries, and Mr. Chavan, Minister for Agriculture, were today seen in the House of Commons.

Mr. Chavan, who is a member of the Indian Cabinet, was today seen in the House of Commons.

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'Syndicate' in disarray as Morarji goes

"The Times of India" News Service

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The Government today announced that the 'Syndicate' of banks, which had been set up to manage the affairs of the nationalised banks, was in a state of disarray.

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A vital step, says Indira

"The Times of India" News Service

NEW DELHI, July 10.

Prime Minister Mrs. Indira Gandhi today said that the nationalisation of the banks was a vital step towards the complete nationalisation of the banking system in India.

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P. M. to keep Finance

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City bankers

City bankers

India: New awakening

- For decades India has continued to be a democracy. Great achievement of 20th century.
- Economically, permit raj led to a complex system of controls and licenses.
- Production, investment and trade were the victims.
- State ownership led to 'sick' companies.
- Hindu rate of growth: 3%.
- Hindustan Fertiliser Corporation: In 1991, 1200 employees were clocking in every day but the plant had yet to produce any fertiliser for sale. The machinery brought for cheap by civil servants did not fit together. Everyone pretended it was operating.
- In 1991, we had a financial crisis.



Manmohan Singh: Father of Indian reforms

India: New awakening

- Post 1991, series of reforms were initiated.
- Privatisation, deregulation, liberalisation.
- Vastly changed the role of the government in Indian economy.

Framework

- Cannot be anarchy: Afghanistan
- Cannot have central planning: Soviet Russia.
- What's a framework through which we can continuously stay on the middle road?
- Key concepts: Market failure, Public choice theory, State capacity.

Framework

- There is no country in the world which works perfectly within the analytical framework.
- All real world States are a complicated mix of the ideal and the political compulsions.
- We are finished with socialism, there is no planning commission, we do not want the State to control the means of production.



HOME COMPANIES INDUSTRY POLICY CONSUMER MONEY OPINION LOUNGE MULTIMEDIA

AIR INDIA

JET AIRWAYS

KINGFISHER AIRLINES

INDIGO

AIRLINE

Regulator to issue new rules on hiring of expat pi

For every expat pilot, an airline will need to hire two unemployed commercial pilot licence holder

Tarun Shukla

First Published: Tue, May 21 2013. 12 23 AM IST



The modern public economics framework

- What's the intellectual framework for thinking about the State?
- In most areas, the best strategy for the government is to not interfere.
- The case for interference is based on 'market failures'.

The modern public economics framework

The free market goes wrong in four cases:

- 1 Market power - e.g. the monopoly of MTNL.
- 2 Externalities - e.g. a factory that pollutes.
- 3 Asymmetric information - e.g. drug adulteration
- 4 Public goods - e.g. safety.

The first test when considering State action should be: "Is there a market failure, which requires the State in the picture?".

Conclusion

- Let's not have illusions about government organisations / agencies. Their objectives diverge ('public choice') and their competence is low ('State capacity').
- We should focus the limited resource and power of government upon a few burning priorities - e.g. safety.
- Build capabilities in public administration.
- *"..the forces of the market are just that: They are forces; they are like the wind and the tides. If you want to try to ignore them, you ignore them at your peril. If you find a way of ordering your life which harnesses these forces to the benefit of society, that's the way to go".*



That's all Folks!