

Globally Free Markets for the Twenty-First Century?

Year after year in Washington, . . . debates seem to come down to an old, tired argument: on one side, those who want more government regardless of the cost; on the other, those who want less government, regardless of the need.

— PRESIDENT GEORGE W. BUSH, ADDRESS OF THE PRESIDENT TO THE JOINT
SESSION OF CONGRESS, FEBRUARY 27, 2001



Capitalism vs. Socialism

- **Capitalism**

- Economic system wherein economic decisions are made by private sector via marketplace and means of production are owned by private sector

- **Socialism**

- Economic system wherein economic decisions are made by public (government) sector and means of production are owned by public sector

Major Regions of the World

- **Western industrialized world**
 - Industrialized capitalist countries of the world
 - EXAMPLES: United States, China, most of Western Europe
- **Formerly socialist industrialized world**
 - Industrialized ex-socialist countries of Eastern Europe
 - EXAMPLES: Former Soviet Union and much of rest of Eastern and Central Europe
- **Less-developed world**
 - Less-developed countries of the world
 - EXAMPLES: Africa, Asia, and Latin America

The Western Industrialized World: Economic Growth

- Many larger democracies of Western industrialized world have taken on conservative philosophy that has resulted in restricted government involvement in their economies and more focus on free markets
 - Domestic social programs have declined; economic growth driving these countries in new century

Economic Growth Rates

**TABLE
17-1**

**AVERAGE ANNUAL ECONOMIC GROWTH RATES, WESTERN
INDUSTRIALIZED COUNTRIES AND JAPAN, 1990–2000 AND
2000–2005**

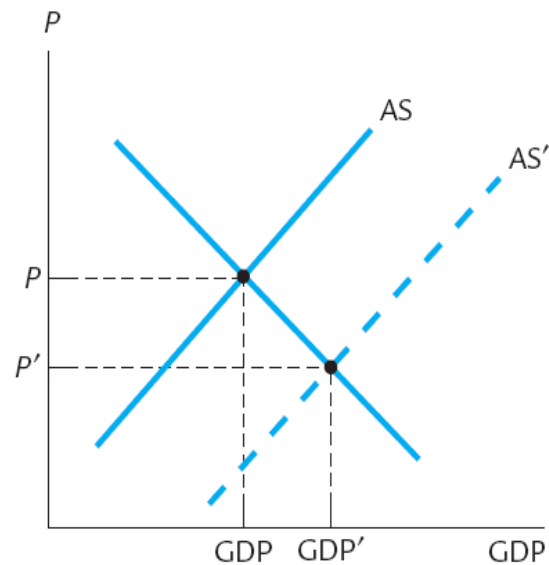
<u>Country</u>	<u>Average Annual Growth of GDP (%) 1990–2000</u>	<u>Average Annual Growth of GDP (%) 2000–2005</u>
Austria	2.4	1.3
Belgium	2.1	1.5
Canada	3.1	2.6
Denmark	2.5	1.5
Finland	2.6	2.4
France	2.0	1.5
Germany	1.8	0.7
Greece	2.2	4.2
Ireland	7.5	5.0
Italy	1.6	0.7
Japan	1.3	1.3
Netherlands	2.9	0.6
Norway	4.0	1.7
Portugal	2.7	0.3
Spain	2.6	3.1
Sweden	2.2	2.2
Switzerland	1.0	0.9
United Kingdom	2.7	2.3
United States	3.5	2.8

Source: World Bank, *World Development Indicators 2007*, <http://www.worldbank.org>.

Effects of Supply-Side Policy on the Macroeconomy

FIGURE
17-1

EFFECTS OF SUPPLY-SIDE POLICY ON THE MACROECONOMY



Supply-side policy is designed to cause an increase in aggregate supply, as shown by the shift of the aggregate supply curve AS to AS' . The result is an increase in GDP to GDP' and a reduction in the average price level from P to P' .

Production Possibilities with Economic Growth

- Production possibilities curve shows alternative combinations of maximum amounts of output that economy can produce if all of its resources and technology are fully and efficiently utilized
 - Economy can achieve higher levels of production if production possibilities curve shifts outward over time
 - Factors that cause outward shift in production possibilities include increase in quantity or quality of society's resources or improvement in technology
 - Factors can generate sustained expansion of output—that is, **economic growth**

Policies to Achieve Economic Growth

- Four factors contributing to economic growth:
 - Increase in capital
 - Improvement in technology
 - Improvement in labor productivity
 - Decrease in unnecessary regulation



An Increase in Capital

- Economic growth can occur if there is sustained increase in quantity of physical capital: that is, increase in nation's stock of factories, equipment, machinery, etc.
 - Increase in capital made possible by increase in investment; investment made possible by saving—either private saving by households and businesses or public saving through government taxes

Savings Rate

- Total savings divided by gross domestic product

T A B L E		SAVINGS RATES FOR THE WESTERN INDUSTRIALIZED COUNTRIES,* 2004
17-2		
<u>Country</u>		<u>Savings Rate</u>
Austria		24%
Belgium		24%
Canada		23%
Denmark		23%
Finland		24%
France		19%
Germany		21%
Greece		18%
Ireland		23%
Italy		19%
Japan		27%
Netherlands		23%
Norway		33%
Portugal		15%
Spain		23%
Sweden		24%
Switzerland		29%
United Kingdom		15%
United States		15%

*Calculated as total savings divided by GDP.
Source: World Bank, *World Development Indicators 2006*, <http://www.worldbank.org>.

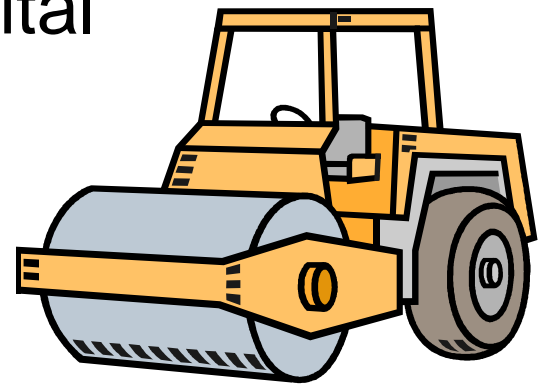
Increasing the Savings Rate through Supply-Side Policy

- Numerous efforts and proposals made to increase national savings rate through supply-side policy
 - Efforts and proposals aimed at increasing incentives for households and businesses to save and invest
 1. 1981 tax law
 - Accelerated tax write-offs for new investment by businesses, greatly reducing corporate income taxes
 - Provided tax breaks to households placing income into individual retirement accounts (IRAs) and 401(k) accounts
 2. Capital gains tax and taxes on dividends, received by shareholders, have been reduced
 3. Repeated proposals for **consumption tax** to replace current personal income tax
 - Like a national sales tax, a consumption tax taxes only share of household income spent on consumer goods and services; does not tax portion of income saved

An Improvement in Labor Productivity

- **Labor productivity**

- Total output per average work hour, calculated as GDP divided by number of work hours
- Hinges on type and amount of capital and technology used in conjunction with labor
- Also depends on human capital



An Improvement in Technology

- Technological advance depends on research and development (R&D)

T A B L E
17-3

**NUMBER OF RESEARCHERS IN RESEARCH AND DEVELOPMENT
(PER MILLION POPULATION), TOP SEVEN COUNTRIES IN
ORDER, 1996 TO 2004***

<u>Country</u>	<u>Researchers per Million Population</u>
Finland	7,992
Sweden	5,416
Japan	5,287
Denmark	5,016
Singapore	4,745
Norway	4,587
United States	4,484

*Most recent available year.

Source: World Bank, *World Development Indicators 2006*, <http://www.worldbank.org>.

Research and Development

- Government policies can be used to encourage research and development
 - Government can increase university funding available for research and offer tax breaks for businesses that engage in research and development
 - Government can provide patent protection to developers of new products
 - **Patent**
 - Government grant of exclusive rights to use or sell new technology or product for period of time

Information Technology

- Nowhere has technological advance been more prominent than in area of computers

TABLE 17-4		NUMBER OF PERSONAL COMPUTERS AND NUMBER OF INTERNET USERS (PER THOUSAND POPULATION), 2004	
<u>Country</u>	<u>PCs</u>	<u>Internet Users</u>	
Australia	682	646	
Canada	700	626	
Denmark	656	696	
Estonia	921	497	
Finland	481	629	
Israel	741	471	
Netherlands	682	614	
New Zealand	474	788	
North Korea	545	657	
Singapore	763	571	
Sweden	763	756	
Switzerland	826	474	
United Kingdom	599	628	
United States	749	630	

Source: World Bank, World Development Indicators 2006, <http://www.worldbank.org>.

A Decrease in Regulation

- Government regulates business in variety of ways, including:
 - Protections for consumers of pharmaceuticals, food, and manufactured goods
 - Safeguards for workers in industry
 - Protection of environment
- In light of recent deaths caused by unsafe tires and certain pharmaceutical drugs, necessity for wisely developed government regulations is clear
- On the other hand, unwise and unnecessary regulation merely increases business costs and decreases output
 - Problem is recognizing which regulations are harmful and which are beneficial

The Twenty-First Century?

- Market-oriented growth policies of Western industrialized world likely to persist for at least near future
 - However, may be cyclical movement of philosophy from restricted government role to expanded government role and back again, as dissatisfaction with drawbacks of either extreme becomes evident

The Formerly Socialist Industrialized World: Economic Transition

- Formerly socialist economies of Eastern and Central Europe now undergoing economic transition toward capitalism
 - Transition has achieved varied level of success, as evidenced by diverse economic growth rates
 - Most prominent elements of transition to capitalism have been movement toward market-determined prices and process of privatization, as well as development of entrepreneurship

Economic Growth Rates

TABLE 17-5 | **AVERAGE ANNUAL ECONOMIC GROWTH RATES, FORMERLY SOCIALIST INDUSTRIALIZED COUNTRIES, 1990–2000 AND 2000–2005**

<u>Country</u>	<u>Average Annual Growth of GDP (%), 1990–2000</u>	<u>Average Annual Growth of GDP (%), 2000–2005</u>
Albania	3.5	5.3
Armenia	–1.9	12.3
Azerbaijan	–6.3	12.7
Belarus	–1.7	7.6
Bosnia & Herzegovina	N/A ^a	5.1
Bulgaria	–1.8	5.0
Croatia	0.6	4.4
Czech Republic	1.1	3.5
Estonia	0.2	7.0 ^b
Georgia	–7.2	7.4
Hungary	1.6	4.0
Kazakhstan	–4.1	10.1
Kyrgyzstan	–4.1	4.0
Latvia	–1.6	7.9
Lithuania	–2.7	7.8
Macedonia	–0.8	1.7
Moldova	–9.6	7.0
Poland	4.6	3.1
Romania	–0.6	5.8
Russia	–4.7	6.2
Serbia & Montenegro ^c	1.5	5.3
Slovak Republic	1.9	4.9
Slovenia	2.7	3.4
Tajikistan	–10.4	9.7
Turkmenistan	–4.8	N/A
Ukraine	–9.3	8.0
Uzbekistan	–0.2	5.3

^aN/A = Not available.

^b2000–2004

^cAt the time of publication, Montenegro had just voted to form a country separate from Serbia.

Source: World Bank, *World Development Indicators 2007*, <http://www.worldbank.org>.

Market-Determined Prices

- Under pure socialism, government sets prices of goods and services
 - Prices had traditionally been set artificially low in socialist economies of Eastern Europe
 - Artificially low prices operate like price ceilings, and result in shortages
- Prices of most items have been allowed to rise to market-determined levels in most Eastern European countries
 - In other words, **decontrol of prices** has occurred
 - Governments no longer set prices
 - Because wages have not always risen as rapidly as prices, purchasing power of consumers has declined

Privatization

- Transfer of government-owned enterprises or responsibilities to private sector
- Throughout Eastern Europe, governments have owned everything from industry and businesses to agricultural land, energy facilities, agricultural marketing boards, and transportation networks
- Process of privatization presumes that private ownership of means of production enhances efficiency and growth

Effects of the Transition

- Objectives of transition from socialism to capitalism throughout formerly socialist industrialized world are greater efficiency and growth
 - But transition has posed many problems for people:
 - Inflation has made it difficult for consumers to afford basic necessities
 - Farmers have been hit hard by increases in prices of inputs such as fertilizer, and prices they receive for food products often still remain artificially low
 - Workers have been laid off in defense industries, government jobs, and privatized businesses, and other workers frequently have not been paid
 - Corruption is often widespread, and organized crime is sometimes rampant

The Twenty-First Century?

- Twenty-first century is a question mark
 - Although policies of liberalization will undoubtedly continue, struggles and dissatisfactions of ordinary people may slow down or change nature of transition
 - In some countries, transition may even be reversed
 - Opinion polls show that large shares of population wish to return to the “old days,” when they were provided with housing, jobs, child care, and medical care
- Critical issue in transition to freer-market economies in Eastern and Central Europe is safety net for people
 - Governments must ensure that people’s basic needs are met

The Less-Developed World: Economic Reform

- Much of less-developed world is undergoing process referred to as **economic reform**
 - Developing countries adopting policies that move economies toward freer markets; are engaged in liberalization
 - Economic reform predominant in 1990s and 2000s has roots in international debt crisis of 1980s
 - That crisis has roots in world economic conditions of 1970s

The 1970s: Oil Crisis

- Most significant economic events of 1970s began with restriction of oil supplies by Organization of Petroleum Exporting Countries (OPEC), Arab oil embargo, and quadrupling of oil prices between 1973 and 1974
 - Among less-developed countries (LDCs), limited number of OPEC countries received massive increases in earnings from oil exports; non-oil-exporting countries suffered huge increases in spending for oil exports

Effects of the Oil Shock

- Effects of oil shock were threefold:
 1. OPEC nations began process of “recycling” oil revenue; deposited much of oil revenue in U.S. and European financial institutions
 2. Oil price increase caused generalized inflation, and subsequent recession, throughout much of world
 3. Combination of reduced export earnings and increased oil import expenditures caused LDCs to borrow from **International Monetary Fund (IMF)**, as well as from commercial banks

The 1980s: Debt Crisis

- Second phase of borrowing funds when OPEC and Iranian oil embargo again sent oil prices soaring in 1979 occurred at time of great concern in U.S. over inflation that was largely generated by escalating oil prices
 - High inflation rates persisted until early 1980s, when Federal Reserve engaged in **contractionary monetary policy**
 - Consequences:
 1. Inflation brought under control, but at expense of skyrocketing interest rates and consequent U.S. recession that later spread worldwide
 2. Since LDCs started borrowing from commercial banks, as opposed to IMF, larger proportions of lending agreements stipulated variable interest rates, which were rising very rapidly
 - » Interest payments by LDC borrowers increased as well
 3. Rising interest rates in U.S. had secondary effect of pushing up value of dollar
 - » Rising dollar made LDC payments for oil imports even more difficult because oil is valued in dollars

LDCs and Borrowed Funds

- By 1988, less-developed countries had borrowed more than a trillion dollars
 - In many LDCs, however, borrowed funds were grossly misused
 - Lenders had so much lending capacity that they neglected to take adequate care in who they lent to and for what purpose
 - Another problem was **capital flight**
 - Process whereby borrowed funds are reinvested in financial markets or real estate abroad
 - Corrupt government officials or businesspeople with access to borrowed funds often invested these funds overseas, rather than using them for local projects
 - » When governments fail to invest borrowed funds productively, naturally hampers ability of borrowing countries to repay debt

Debt Repayment

- Amount of money that must service debt (interest payment plus repayment of principal) represents large expenditure in any particular year
 - **Debt service** of LDCs meant that significant proportion of gross national income was transferred out of country
 - Since gross national income of LDCs is typically small, any expenditures toward repaying debt will directly harm well-being of people

Debt Repayment (cont.)

- In addition to problem of allocating income for debt servicing, is a problem of form that transfer must take
 - Debt repayment must be made in form of currency initially borrowed; thus, repayment must typically be in U.S. dollars or in currency of other major countries (i.e., “hard currency”)
 - LDCs have very limited means of obtaining hard currency with which to make payments
 - May earn foreign currency through:
 1. Exports to other countries
 2. Foreign investment by other countries and international assistance
 3. Continually borrowing to repay past debts

The 1990s: Economic Reform

- Final phase of debt crisis occurred as many countries were forced by inability to meet payment schedules to seek financial assistance from International Monetary Fund
 - IMF assistance has typically involved **conditionality**, forcing countries to undertake vast number of economic reforms as condition for assistance
 - Reforms include requirements that government:
 - Reduce spending
 - Privatize government enterprises
 - Allow food and other prices to rise to market levels
 - Reduce controls on foreign trade and investment

The Twenty-First Century?

- Less-developed countries have had mixed reactions to economic reforms
 - In many countries, privatization has resulted in massive layoffs of public-sector employees
 - In other countries, rising food prices have been met with riots
 - In still other countries, economic reforms have created rapid economic growth and national prosperity
- Hoped that economic reform throughout less-developed world will lead to economic growth and that benefits of growth will reach poor, but at least in short term, poor are ones who suffer most
 - Critical issue is existence of adequate safety net for poor
- Many rejecting notion that economic reform, along with capitalism and market-based economy, will ultimately benefit poor
 - Turning toward versions of socialism in reaction to failures of conservative policy

The Economic Left and the Economic Right

- THE ECONOMIC LEFT (**Liberal**)

- See marketplace as imperfect and believe that markets are not necessarily equitable, and sometimes not even efficient
- Prefer more government regulation

- THE ECONOMIC RIGHT (**Conservative**)

- Maintains that free markets are efficient and provide proper incentives for economic prosperity and growth to occur
- Prefer less government regulation