

## Basics of Economic Policy

**„Nothing is politically acceptable that is morally incorrect”**

# Basics of Economic Policy

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# The absolute goal of Economic Policy

To maximize welfare, “the quality of life”

- Environmental capital (ecology)
- Physical capital
- Human capital
- Social capital (abstract)

# Economic Policy

**First approach: art.**

“Art of maneuvering between opportunities and constraints.”

## **Right brain lobe**

opportunities: ideas, solutions, best practices, visions

## **Left brain lobe**

constraints: means, numbers (inherited balance of revenues and expenditures), inherited systems, institutions, intentions of actors

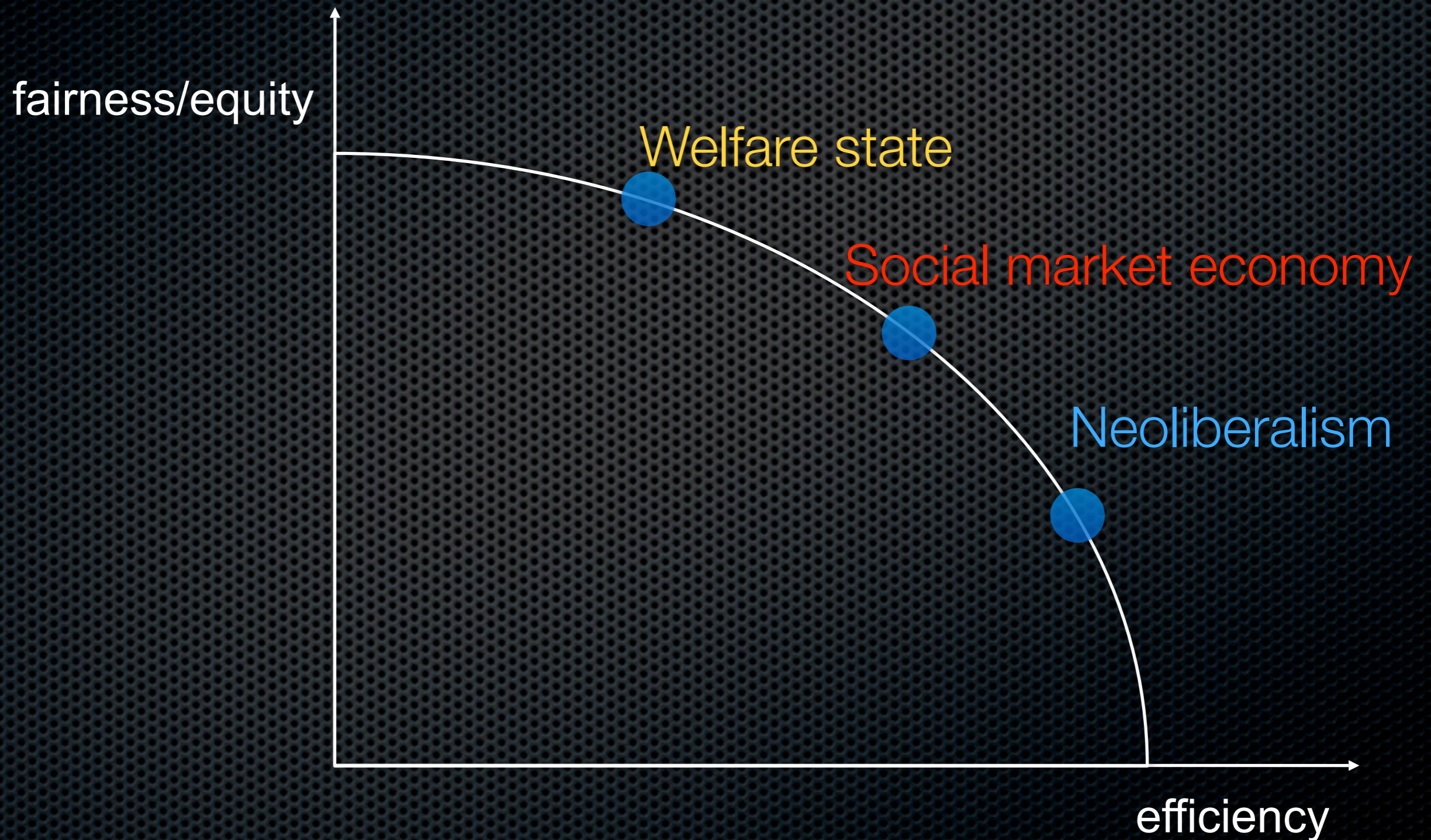
Goal: maximize social welfare

# Constraint of “Isolationability”

EC is not a ceteris paribus lab experiment

# Economic Policy

Second approach: the unavoidable choice.

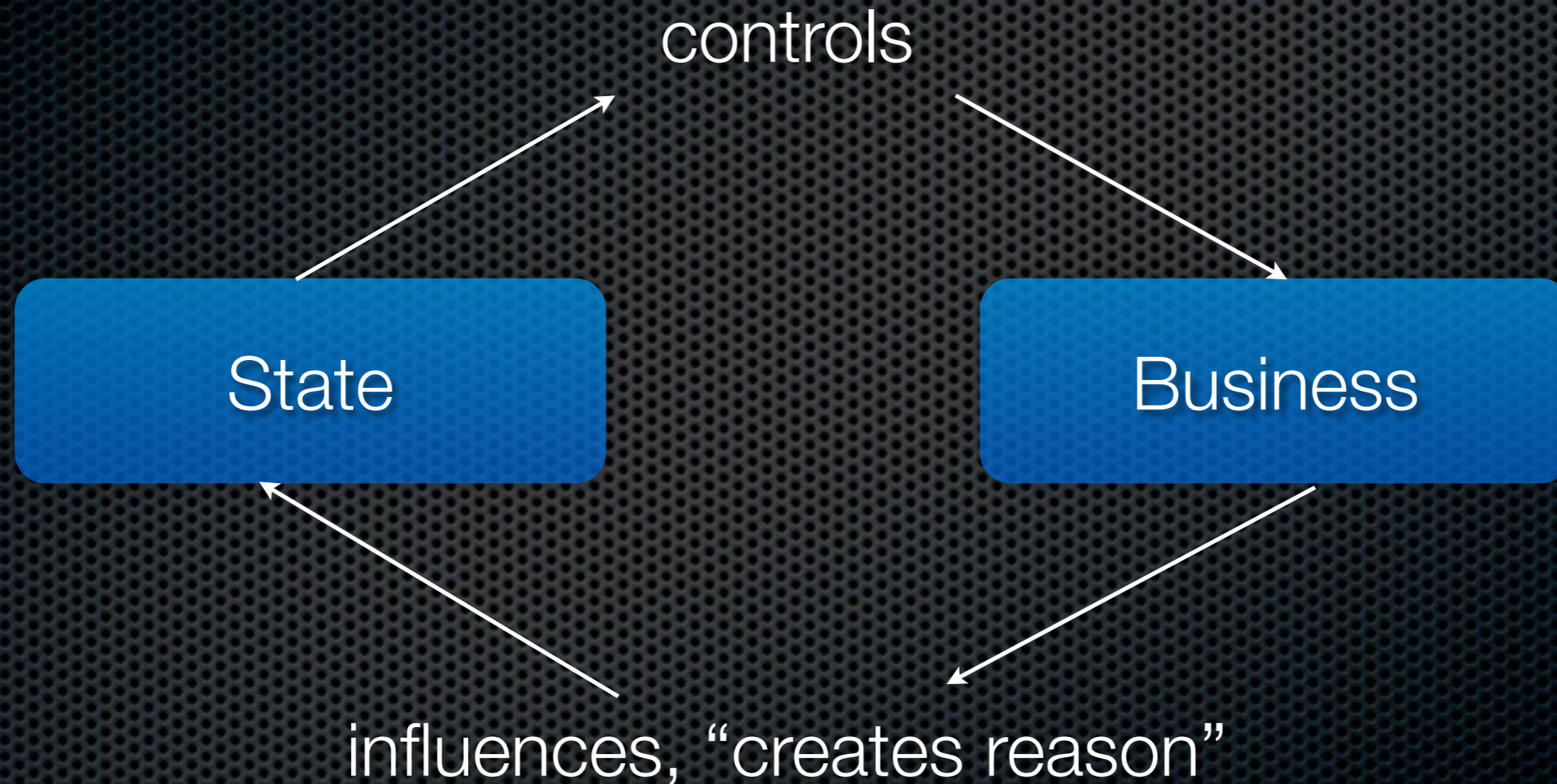


# Economic Policy Regimes

<b>Regime</b> <b>Characteristics</b>	<b>Welfare state</b> (North European states)	<b>Neoliberalism</b> (England in the 80s, USA under Bush)	<b>Social Market Economy</b> (Germany before reunification)	<b>Asian modell</b> (Singapore, China)
<b>About competition</b>	Bad, but necessary	The best thing	Neutral (accepts its existence)	International competition is more important than domestic
<b>About the social welfare net</b>	Universal (for everyone, selectivity is secondary)	Only for the very poor	Selective	Primary family issue, state support only for the very poor
<b>About the role of economic policy</b>	Aim of full employment	Maximizing the role of markets	Where there is no market....	Sustain development
<b>Business/government relations</b>	Business for the society	Government for business	Partnership	Business for government

# Economic Policy

Third approach: relation between the state and business.





# Example

Then and now.



Lee Kuan Yew



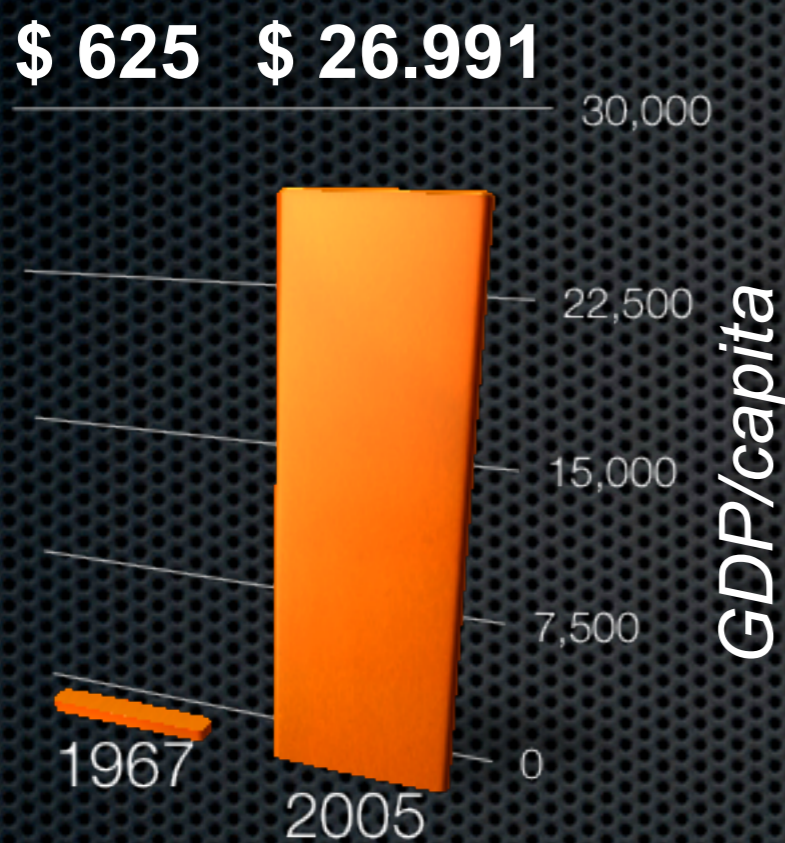
Suharto



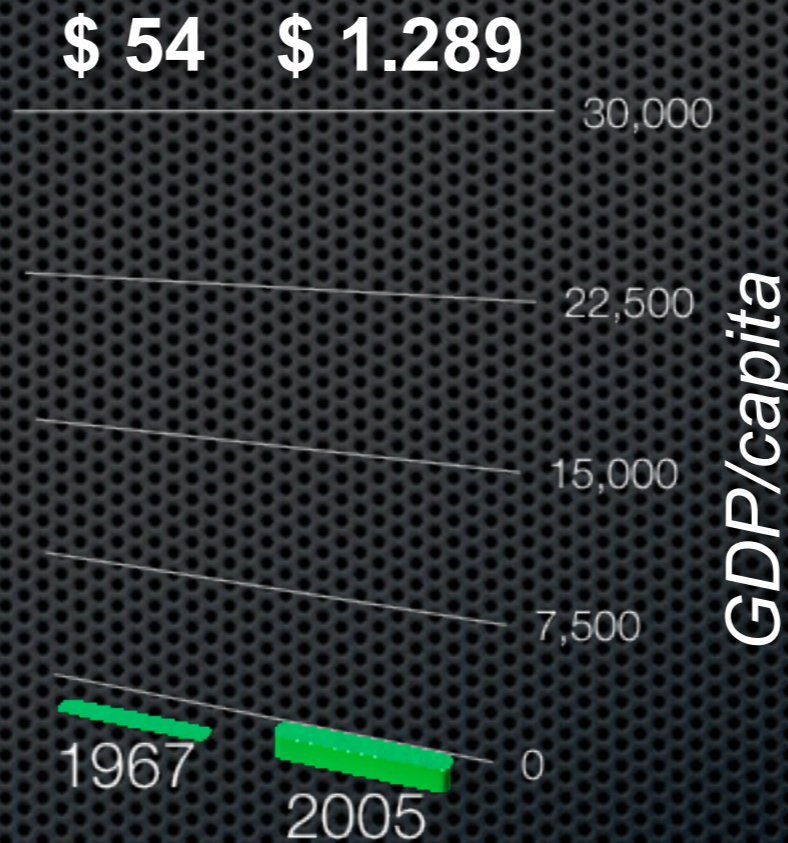
János Kádár

# Example

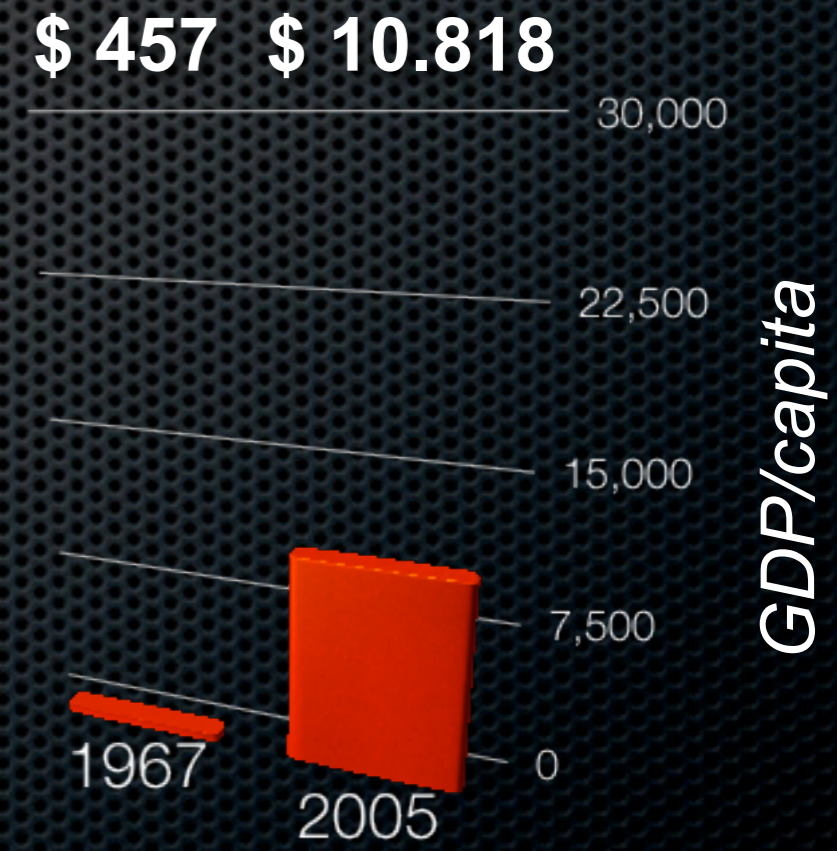
Then and now.



Singapore (43x)



Indonesia (23x)



Hungary (23x)

# Example

Then and now.



Singapore in the 1950s



Singapore nowadays

# Example

Then and now.



Jakarta today



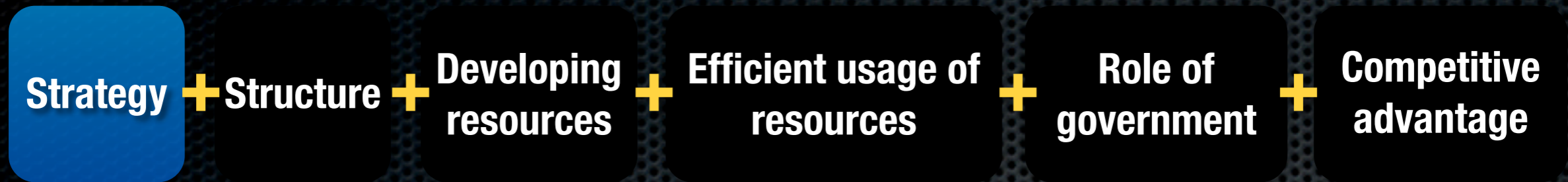
Jakarta today

# Economic Policy

First + Second + Third approach.



**Sustainable development of the  
nation-state (and the global  
economy)**



**Explicit:** carefully discussed and formulated

e.g.: USA, 1981, Ronald Reagan:

1. reduce inflation
2. get the economy growing again
3. reduce the size and the role of government
4. strengthen national security

**Implicit:** loose collection of goals and policies

e.g.: China, after 1978, Deng Xiaoping

„economic growth” and „political stability”

„It doesn't matter if a cat is black or white, so long it catches mice”



## Macroeconomic

(technocratic approach, optimizing, adding subtracting)

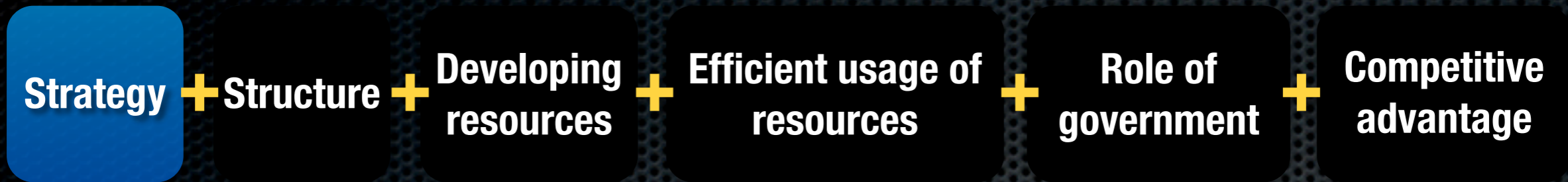
## Microeconomic

(ideologies, best practices, philosophies)

## Social policies)

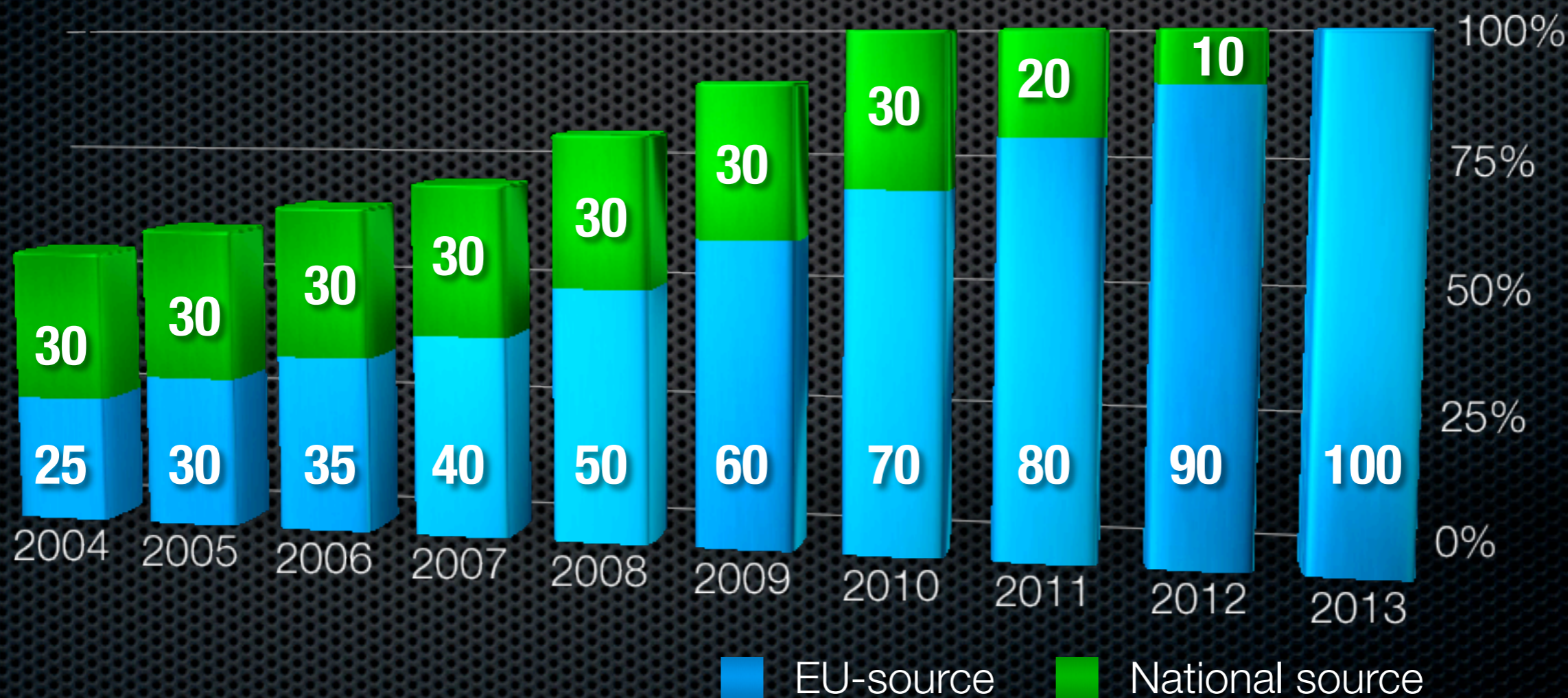
(ideologies, best practices, philosophies)

Goals	Means	Goals	Means	Goals	Means
Unemploy. ↘	FISCAL taxes expenditures	Correcting market failures	COMPETITION POL.	Easing social tensions	EDUCATION
Inflation ↘			INDUSTRY POL.		
Balance of Payments	MONETARY money a/o interest rate	Industry dev.	TRADE POL.	HOUSING POL.	INCOME POL.
Economic growth		Unemploy. ↘	EMPLOYMENT POL.		
	EXCHANGE RATE		REGIONAL POL.		



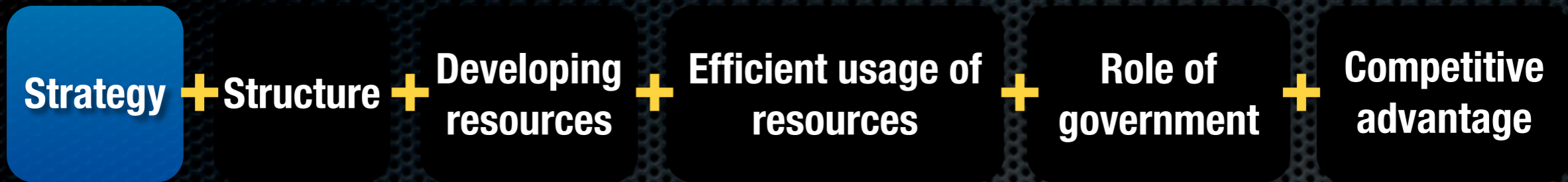
# CONSTRAINTS (e.g.)

Agrarian subsidies: timing of direct subsidies in Hungary in the transition period



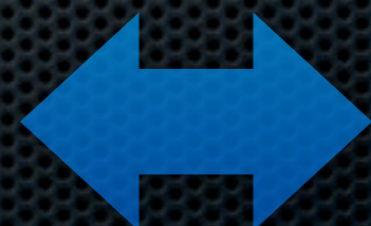
Source: Ministry of Foreign Affairs ([www.kum.hu](http://www.kum.hu))





Macroeconomic (technocratic approach, optimizing, adding subtracting)		Microeconomic (ideologies, best practices, philosophies)		Social policies (ideologies, best practices, philosophies)	
Goals	Means	Goals	Means	Goals	Means
Unemployment. ↘	FISCAL taxes expenditures	Correcting market failures	COMPETITION POL.	Easing social tensions	EDUCATION
Inflation ↘			INDUSTRY POL.		Provision of even chances
Balance of Payments	MONETARY money a/o interest rate	Industry dev.	TRADE POL.	HOUSING POL.	INCOME POL.
Economic growth		Unemployment. ↘	EMPLOYMENT POL.		
	EXCHANGE RATE		REGIONAL POL.		

**DETERMINATION,  
RESPONSIBILITY BROADENING**



**DOMAIN, CODOMAIN  
NARROWING**



**goals, macro- and micro-economic decisions**

<b>BUDGET REVENUES (GDP %, 2005)</b>										
<b>Asian countries</b>				<b>Europe</b>						<b>Am.</b>
<b>China</b>	<b>India *</b>	<b>Singapore*</b>	<b>Korea</b>	<b>Belgium</b>	<b>Bulgaria</b>	<b>Germany **</b>	<b>Hungary**</b>	<b>Slovakia**</b>	<b>UK**</b>	<b>USA</b>
<b>18</b>	<b>12</b>	<b>20</b>	<b>23</b>	<b>49,2</b>	<b>38</b>	<b>44</b>	<b>43,7</b>	<b>33,9</b>	<b>41,4</b>	<b>18</b>



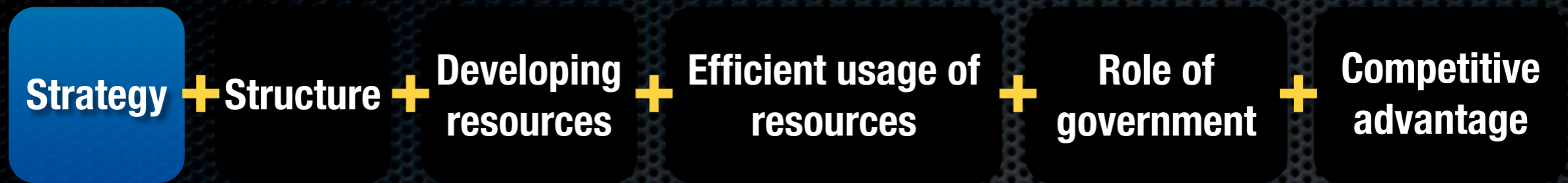
## environment

**Strategy**



**Structure**

**International politics, geopolitics**  
**Intentions of business (financial) leaders**  
**Culture, size, geographic position of a certain country**  
**Degree of corruption**  
**Natural resources**  
**Quality of education**  
**Income distribution**  
**National security**  
**Historical heritage (pl. India – British Colony, South-Africa - Apartheid)**



## Policies

### Macroeconomic choices

- **Fiscal policy** (determination of the amount and structure of governmental expenditures and revenues in accordance with the goals of economic policy)

E.g.: defence, research, infrastructure investment, or social entitlements  
Choices of taxation



## Policies

### Macroeconomic choices

## 2. Monetary policy (and exchange rate policy)

**Goals:** create enough money to finance healthy economic growth **without inflation** and to sustain adequate reserves of foreign exchange

**Means of monetary policy:** Money supply (means: interest rates, reserve requirements and open market operations)

**Means of exchange rate policy:** either float currency freely at market rates or fix the price in some other currency or manage its appreciation or depreciation, employ controls on capital accounts



## Policies

### Macroeconomic choices

## 2. Monetary policy (and exchange rate policy)

### THE IMPOSSIBLE TRINITY

A country must pick two out of three. It can fix its exchange rate without emasculating its central bank, but only by maintaining controls on capital flows (like **China today**); it can leave capital movement free but retain monetary autonomy, but only by letting the exchange rate fluctuate (like **Britain--or Canada**); or it can choose to leave capital free and stabilize the currency, but only by abandoning any ability to adjust interest rates to fight inflation or recession (like Argentina today, or for that matter most of **Europe**).

Fixed exchange rate



Free capital movements

Independent monetary policy

# Bretton Woods System????



## Policies

### Microeconomic choices (6 important)

#### 1. Trade policy

**Goals:** foster domestic economic development (and consumption) through import substitution

**Means:** tariffs, quotas, taxes on imports (and exports)  
(100-200% of price → 2-30%)

8 round of negotiations in General Agreement on Tariffs and Trade (GATT/WTO) 1947-1995



## **Policies**

**Microeconomic choices (6 important)**

### **2. Restriction and promotion of foreign direct investment (FDI)**

#### **Goals:**

restriction: protect domestic firms from foreign ownership or from foreign competition foster domestic economic development (and consumption)

promotion: competition, employment, new technology (China, Singapore, Canada)

#### **Means:**

controls on capital accounts





## Policies

Microeconomic choices (6 important)

### 3. Nationalization or privatization

#### Goals:

nationalization: protect consumers from monopol pricing, favor sectors

privatization: increase efficiency

Affected sectors: utilities (oil, gas, electricity, railroads, airlines and telco), banking, important heavy industries (steel, shipbuilding, automobiles)

Most privatized: USA, England

Less privatized: Saudi Arabia, Turkey, Brazil

In the middle: France, Singapore, China, India



## Policies

**Microeconomic choices (6 important)**

### 4-5. Economic regulation and competition policy

**Goals:** correct some perceived economic flaw

natural monopoly

moral hazard

externalities



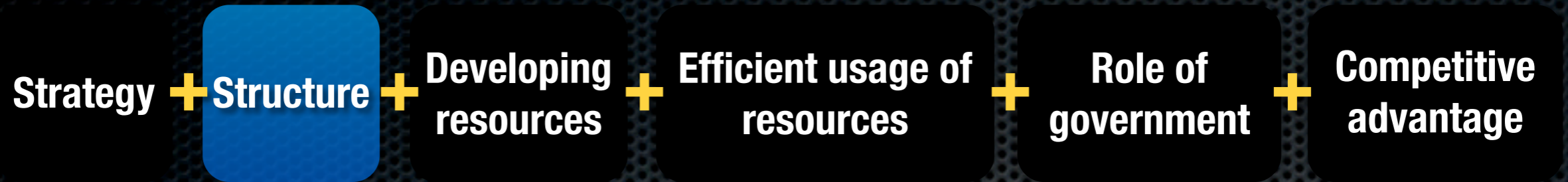
## Policies

**Microeconomic choices (6 important)**

### 6. Industrial policy

**Goals:** affect industry or sectoral growth

**Means:** subsidies such as direct grants, tax remissions, help with inputs, government purchasing



political, economic, institutional

## Political structure

democratic, autocratic, Communist

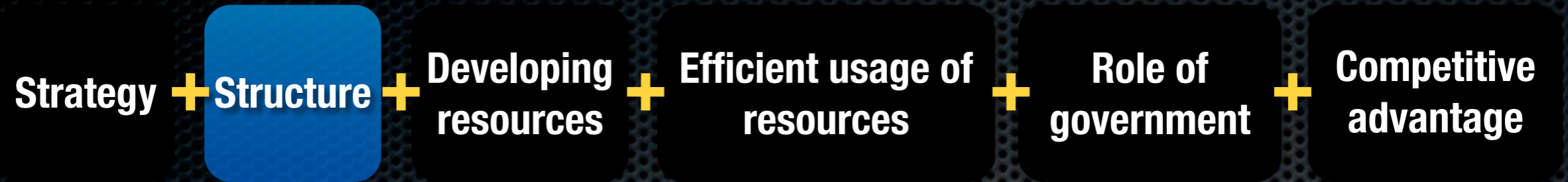
...and many others... wide variations of these pure structures

e.g.: Japan – Liberal Democratic Party 1949-

Singapore – People's Action Party 1959-

Fragmented democracy: Turkey, Italy

Two-party variety: USA, England, (Hungary)



political, economic, institutional

## Economic structure

$$\mathbf{GDP=Y=C+G+I+(X-M)}$$

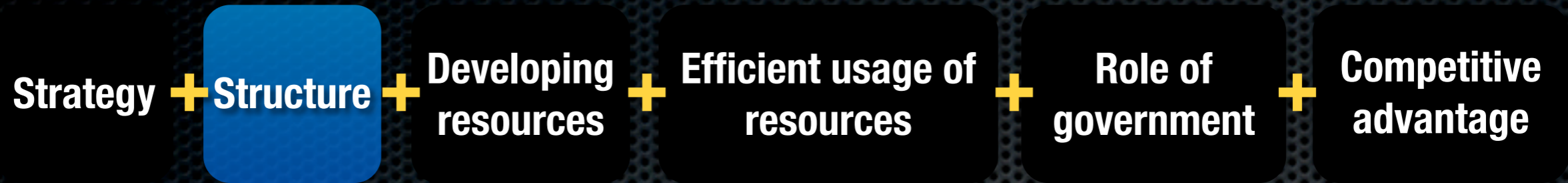
$$Y_d=Y-T-R+TR$$

$$Y_d=C+S$$

Ownership structure (private vs state owned)

Income distribution

Sectoral share: services + manufacturing + agriculture



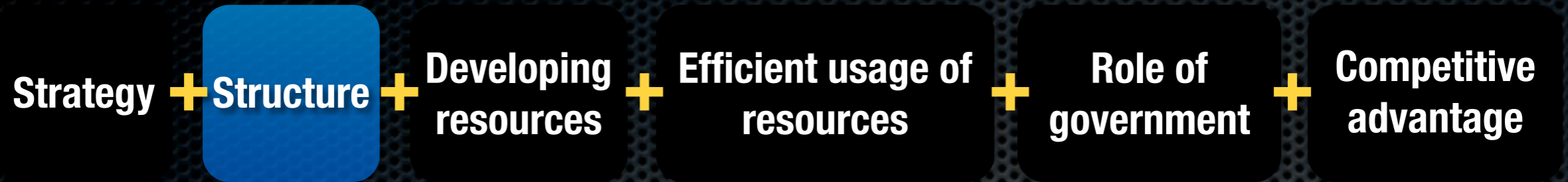
political, economic, institutional

## Economic structure

### TAX WEDGE: tax burden on average earnings

Single persons without children at 100% of average earnings  
Income tax plus employee and employer contributions less cash benefits as a % of labour costs in 2005

Hungary	50.5%
Sweden	47.9%
Germany	51.8%
USA	29.1%
Korea	17.3%
France	50.1%
Spain	39.0%
Japan	27.7%
Greece	38.8%



political, economic, institutional

## Institutional structure

### Institutional structure

Banking system

Court systems

Police

Military

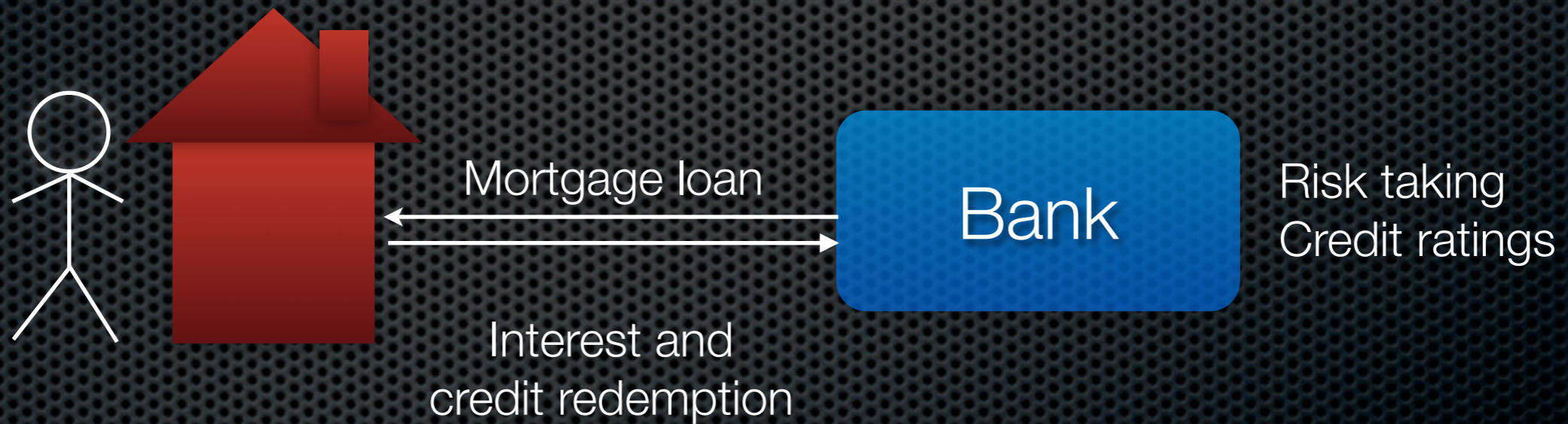
Rule of law (Russia?)

+ labor management arrangements, savings systems (CPF in Singapore), the nature of bureaucracies, the separation of power between legislative and executive branches, the differential powers of federal and government (China)



political, economic, institutional

## conventional bank-system

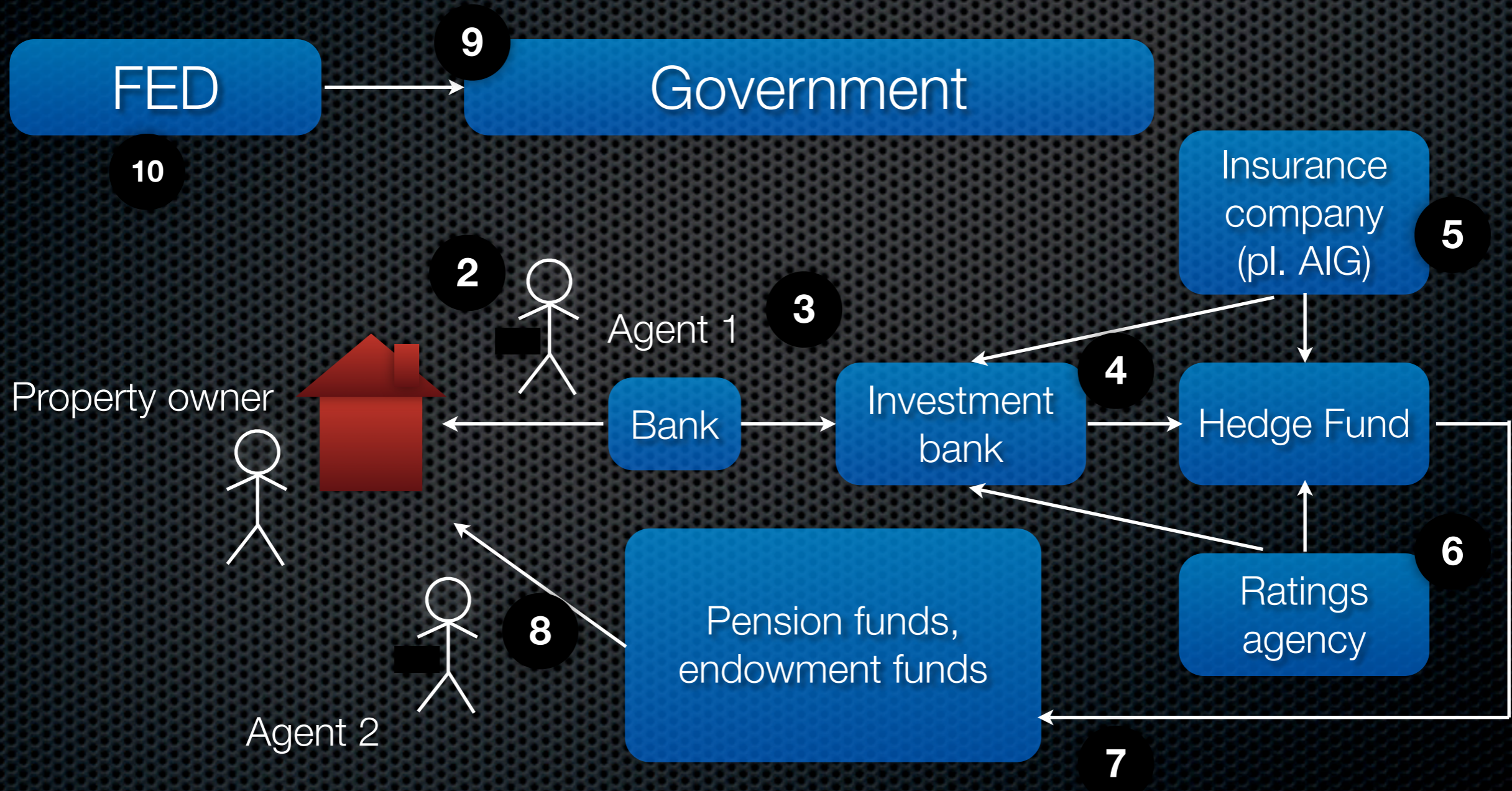


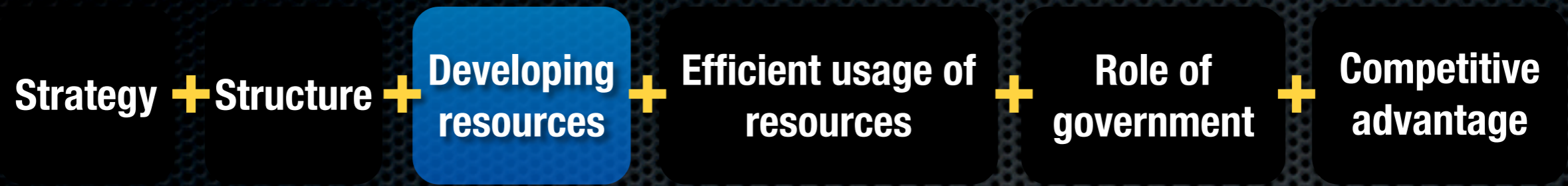


# “Crisis” bank-system

1

After 9/11 2001, federal funds rate=1%, inflation(ex post)=2-3%  
dangerous (at negative real interest rate, almost every investment  
seems to be feasible)





natural, human, technology and capital

### Natural resources

Arable land, energy fuels, vital minerals

Good or bad?

„Dutch disease”: overvalued currency undermines competitiveness,



natural, human, technology and capital

### „Human resources”

Education policy, development of human resources

Quality and quantity of human resources

Different strategies

**Japan: excellent primary and secondary education**

**USA, UK, France: developed higher education**

**Germany: „Duales Bildungssystem”**

**India: 5 million college graduates annually – IIT (Indian Institute of Technology)**

**China?**

Strategy + Structure + Developing resources + Efficient usage resources

natural, human, technolo

## Who is Yao Ming?

Height: 2,27 m

Weight: 141 kg

Annual revenue:  
USD \$32 million





natural, human, technology and capital

## Technology

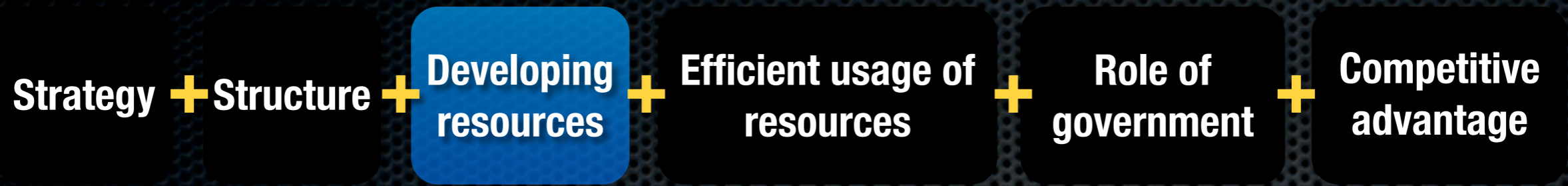
Informal education through companies (FDI) i.e. transferred technology, managerial skills, know-how

Different strategies

**USA, UK, France: strong institutions (patent office), protection of intellectual property rights**

**Japan: copying and innovating**

**China?**



natural, human, technology and capital

## Capital

1. **Debt from domestic banks** (Japan, Singapore, China)

2. **Domestic equity**

well-developed equity markets, investment banks, discount brokerages,  
direct purchasing online.

Venture capital market

Efficiency except bubbles like dot-com bubble

3. **FDI** (Canada, Singapore, China)

4. **International Foreign Debt Financing**

Mainly after the World War II, and the oil shocks 1971-

Debt crisis 1982 Mexico... until 1988 37 countries went broke... then came  
IMF as „the lender of last resort” and „Washington Consensus”



Foreign competition

**BMW in South Africa**

**Italy has developed a host of craft Industries in regional clusters**

Domestic competition

**precondition: big market e.g. USA, since 1890 – powerful antitrust tradition, no state-owned firms**

Competition for FDI

**China: „economic and technological development zones”, incubator houses, infrastructure**

Administrative allocation

**+ Japan, Singapore**

**- Russia, Soviet Bloc countries**



1. Ensuring the social, economic and judiciary framework (Designing and maintaining rules of game)

2. Maintaining competition

3. Redistribution  
(+ backing unexpected risks)

4. Allocation of resources

5. Stabilization

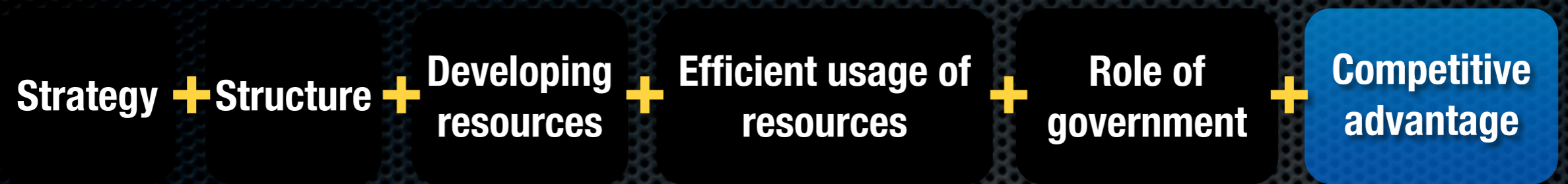
Boom and bust policy (implicit or explicit)

Crisis management

“Ordnungspolitik”

“Prozesspolitik”





To be  
continued.....