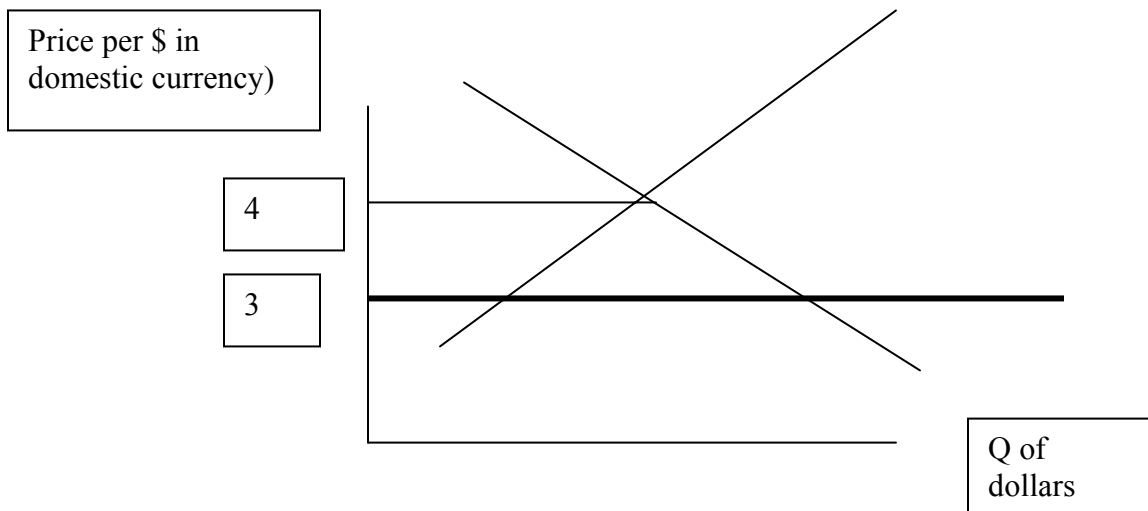


Session Notes –06
For Wednesday, Jan. 27, 2003

- 1. What is an overvalued exchange rate for? Cost of foreign currency is artificially too high or too low?**

The analysis of effects of overvalued exchange rate:

Intent: Many developing countries in ISI attempted to keep the prices of imported raw material or capital goods, or assembly lines etc, cheap. As their foreign currency price may be high they artificially kept the value of foreign currency low.



So dollar is 3 pounds Egyptian while it should be really 4 pounds E worth!

This means that if a good is \$1 in US, you buy it at 3 pounds instead of 4 pounds, a 25% off the price.

What are the exporters in this economy getting for their exports? With market rate, they would receive 4 Eg pounds for every \$1 worth they sell in the int'l market. Now they only receive 3 Egypt Pounds. So

The effects:

Q of \$ demanded > Q of \$ supplied. Since Egypt pays for its imports by \$ and so demands \$ and sells Eg pounds, obviously, it means that Egypt runs a balance of trade deficit, usually this implies a loan or withdrawing of reserves (gold).

The deficit as a loan implies presence of foreign debt!

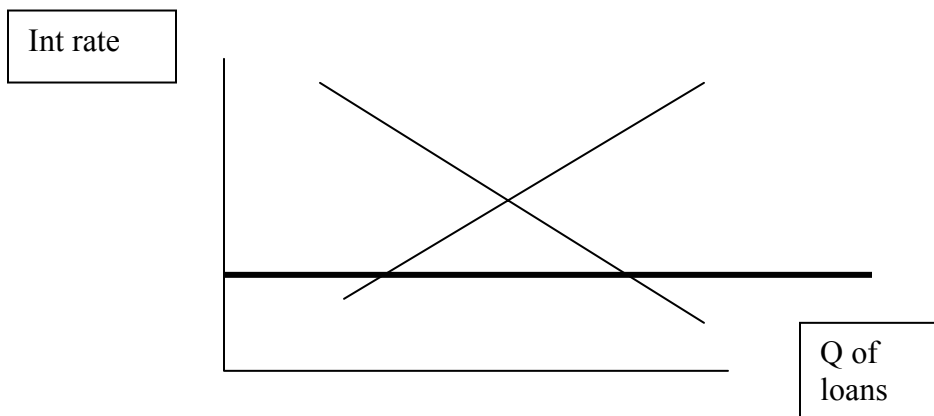
To get out of the problem, the Eg gov. may impose a multiple exchange rate system, only cheap rates for capital goods imports. Travelling multiple exchange rate system outside the country you have to pay 4 pounds per \$. Where is the incentive to cheat here?

The effect on agriculture? As food is bought artificially cheaply, how does that affect the incentive for domestic farmers? Free or otherwise?

What happens to the farmer? They will be quite poor and oppressed! Many leave the rural areas and as towns people are nicely taken care of, they move to urban areas! This also leads to a process of rural-urban migration.

The effects of fixed interest rates:

To encourage borrowing and hopefully investing in industrial projects the government fixed many prices including the cost of loans. Sometimes the inflation rate was higher than the nominal interest rate and so the real int. rate was indeed negative!



What are the effects? The quantity demanded exceeds the Q supplied!

Rationing has to occur. How do we disburse the scarce funds? The low interest rates below inflation means that if the borrower can actually get hold of the funds they will be able to benefit from the negative rates (the borrower makes money!) without having to invest them in “productive” projects!

Do we see the most productive projects undertaken in this economy or may we have some low productivity projects here?

If someone had a great idea but didn’t know any authorities in the high places or did not want to pay bribes, their project would not be done and they would be unable to borrow!

Low fixed interest rates allow for less productive projects to be implemented. (The piece from the article on Iran’s interest rates!)

The whole system turned into one of protecting vested economic interest of particular (usually industrialists, not workers or poor people). The economy was not driven by “merit” but by personal relationships cultivated for the purpose of getting hold of “rents” or getting some thing out of the system.

[You can explain a lot of personal relationships—if an act of kindness is performed, a (an economic) return is usually expected! Because a lot of personal relationship is required to get anything done, there is a lot of that type of relationship for “business” purposes!]

The ISI that keeps country insulated and also tends to create a foreign debt problem:

The economy has few exports: much of its agriculture is in ruins as it has to import, not export food! It has probably no industrial exports to speak of as the “infant industries” never grew up from babyhood! They have a large import bill for intermediate good and food at overvalued exchange rates!

So they turn to international organizations (WB and IMF) for help.

Which countries have had to go thru structural adjustment programs, when?

What the result of all these controls?

The Picture of an economy with full set of government controls:

- **The economy is inefficient. The allocating role of prices (and wage for labor) and the invaluable information they provide for people in market to make decisions is not there and so the economy suffers.**
- **Rent seeking and unproductive activities abound**
- **Vested interest of groups of industrialists- corruption is rampant.**

- **Vested interests of groups of poorer urban population to keep consumer food and other service subsidies going.**
- **Rural - Urban Migration and accumulation of large nos. of people from villages who are unskilled and poor and are living off the gov food subsidies etc. if ever these subsidies are to be lifted their survival is endangered. [In MENA mosques take care of the poor and needy and when the regime turns unpopular, the mosque rises up as the great savior].**
- **A rather large government deficit to finance all the cheap food and other low priced services as well imports of intermediate and capital goods.**
- **Foreign debt and not much to show for it!**
- **All this and we haven't yet discussed the population and human capital issues even!**
- **The whole thing is one large intertwined web of inefficiency, corruption, and debt ridden economies, and rent seeking and regimes that are buying legitimacy by feeding their people cheap food.**

In this picture walks in the WB and IMF. What are they going to suggest? SAPs!

Taking off consumer subsidies, privatization, reducing government deficit, stabilization and reducing inflation rates, liberalizing trade.

The Role of Institutions in Economic Development—A transaction cost approach

Having all the right market game is not sufficient to having a well functioning advancing economy!

What do we mean by the transaction cost of an exchange?

*“Most economists assume exchange is costless”. Or, that the costs are trivial. “In fact the **costs of transacting** are the key to the performance of economies.”*

Two important concepts:

What are transaction cost and production cost?

Prod. Cost is the AC of producing a good. (Using technology, K and L). Transactions costs is the cost of deciphering the salient features of what you buy. Knowing what it is that someone is selling you.

Examples: If you buy a new car, generally you know it is good (can be a lemon but you can exchange it). But if you buy a second hand car, you are not sure why the seller is selling it and even if the person says a reason, you may not trust him. In this case there is a transaction cost of determining whether the car is really worth the price. George Akerlof of Berkeley has a classic paper on this idea of transaction cost approach to understanding the problem posed by “asymmetry of information” between buyers and sellers.

The analysis of the effect of asymmetric info. Is easy: say a good second hand car is \$10,000 worth and a bad one is \$5000. From the look of second hand car, we don't know which one it is. The average price is \$7500. You as a buyer may be willing to pay the average, but one of these sellers will not supply his car: the seller of the good car! So what type of cars are actually traded? The bad cars! There is a market for good cars...but the market will not be realized.

The examples are: second hand car market, health insurance for elderly, market for rice and milk in developing countries. {The milk has water in it. People want milk w/o water but they will not get it—due to the market failure of the existing asymmetric info}.

So, transaction costs of exchange are costs of deciphering information about the good that is being transacted.

There are 4 major variables determining the cost of transaction:

1. Costs of measuring the valuable attributes of goods and services
2. cost due to the size of the market and complicated impersonal exchange. Kinship ties, knowledge of the person, all play part in eliminating cheating.
3. Enforcement of contract in the case of disputes, awarding compensation.
4. Specialization and division of labor also increase transaction costs because they produce a divergent perception of reality (as opposed to uniform understanding in personal exchange), conflicting views on fairness and justice of institutional arrangement.

What are the various costs of transaction and in this regard, how is “personal exchange” different from “impersonal exchange”?

In the simple model of “personal exchange”:

Small communities with repeated dealing between participants. Here the transaction cost of exchange are small. But also production is on a small scale and economies of scale can not be exploited. In other words, while transaction cost is small, production costs are large for the kind of goods (or services) where larger operations will yield smaller AC. The prevalence of dense social interaction keeps cheating, shirking, etc. down. Small town markets.

In impersonal exchange:

“In the other extreme for personal exchange is a world of specialized interdependence in which the well-being of individuals depends upon a complex structure characterized by individual specialization and hence exchange ties extended in time and space”. Pp. 420

Those on either side of transaction don't each other, there may not be repeated dealings! In which case, how do you compare transactions costs of impersonal exchange to those of personal exchange? While the production costs (due to economies of scale) are much lower, transactions costs are much higher. Generally, the characteristics of what is exchanged are not known by the buyer (or seller) and the two sides don't know each other and so there is plenty of room for cheating and shirking. This type of more

advanced market based system economy will not develop unless we have ways of lowering transaction costs.

How do we lower transaction costs?

Institutions like guarantees, warranties, brand names, chains like McDonalds, customer service that allows you to bring goods back!, etc. all reduce transaction costs.

North goes on to determine an important role for gov. : These institutions themselves depend on even more complex structure of property rights defined by one institution above all: government. They are also enforced by government.

Therefore, in order for western economies to grow, we have replaced personal exchange (which does not need third party enforcement) with “impersonal exchange” with third party enforcement.

The impersonal exchange with third party enforcement is the essential requirement for sustained growth and this, Douglas North asserts, is a long and gradual process for the west. It can not be done overnight for developing countries.

Therefore a large and powerful government (not in the sense of feeding population artificially low priced food, but one that can settle debts, enforce property rights and reduce costs of transaction) is in fact essential to the economic development of market economies.

Application: The rules for marriage in developing countries?!!