

**OPENING ADDRESS “MARKETS AND GOVERNMENT: STRIKING A
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Ladies and gentleman, friends and colleagues, good morning.

Introduction

1 Economic policy is at an inflexion point. The financial crisis of 2008-2009 has altered the way we perceive the free market.

2 The idea that competitive markets are sufficient to ensure efficient outcomes and stable economies is under heavy intellectual fire. Barry Eichengreen says the crisis has *“cast into doubt much of what we thought we knew about economics”*. Paul Krugman says that much of the past 30 years of macroeconomics was *“spectacularly useless at best, and positively harmful at worst”*.

3 But rumours of the demise of market-based economics are premature. Gary Becker reminds us, *“... free markets sometimes don't do a very good job ... but if I take the first proposition of Chicago economics - that free markets generally do a good job - I think that still holds”*.

4 What kind of new economic paradigm will emerge from the crisis? This question is not just about economics. The crisis has prompted a fundamental re-think of the relationship between markets and governments. The contest is not just between economic theories but between competing systems of political economy and models of governance. When President Sarkozy says, *“Laissez faire is finished”*, what he means is that the Anglo-Saxon model of market capitalism

has failed and that we should perhaps look to the Continental European model of stakeholder capitalism and social consensus.

5 Likewise, the balance between markets and government is the central issue in policy debates over economic development. What is the role of governments in promoting economic growth? What can governments do to seize the opportunities of globalisation while minimising its downsides?

Markets and Government - A Historical Perspective

6 The tension between markets and government is not new. It has been the central issue in the evolution of political economy over the last 200 years. There have been three distinct phases in this evolution.

7 The first phase could be called ***the rise of the market***. It began in the late 18th century, shaped by the writings of Adam Smith and David Ricardo. The “*invisible hand*” of the market guided supply and demand towards equilibrium and efficiency. Free trade promoted specialisation along the lines of comparative advantage and fostered economic growth. There was no need for central planning, beyond providing public goods like law and order. There was no macroeconomics as such – no monetary policy, no fiscal policy.

8 This phase came to an end in the 1930s, when the concept of self-correcting markets collapsed under the weight of the Great Depression. Falling prices, instead of bringing demand and supply into equilibrium, locked the world into a deflationary spiral. Thus began the second phase – ***the rise of government***. John Maynard Keynes argued that markets were inherently unstable, and left on their own, may not always self-correct. Government intervention was necessary to boost aggregate demand during periods of high unemployment. Modern macroeconomics was born.

9 The rise of government went beyond aggregate demand management. The 1940s also saw the advent of the *welfare state*. Following the *Beveridge Report*, the United Kingdom – and soon, the rest of Europe – embarked on providing social insurance for healthcare, education, employment, and social security. It was enabled through redistributive taxation and government regulation. Across the Atlantic, *Lyndon Johnson's Great Society* of the 1960s expanded the role of the state in pursuit of social justice.

10 The third *phase may be called **the return of the market***. It began with growing disenchantment with government's ability to deliver. The stagflation of the 1970s – persistently high inflation and unemployment - called into question governments' ability to fine-tune the macroeconomy. The welfare state began to impose an unsustainable fiscal burden, not to mention a creeping entitlement mentality among the people.

11 Friedrich Hayek and Milton Friedman led the charge against *Big Government*. They argued eloquently how an overreaching government dulled the fundamental human instincts that power the capitalist system: initiative, enterprise, and the competitive spirit. The idea that markets – for all their faults – were more effective than governments in allocating resources and driving structural change, gained ascendancy.

12 The 1980s saw Ronald Reagan in America and Margaret Thatcher in Britain reduce taxes, deregulate industries, privatise state-owned enterprises, curb union power, and scale back welfare programmes. The global economy boomed. The collapse of the Soviet Union and the opening up of China seemed to vindicate the triumph of market capitalism. The *Washington Consensus* held sway from Bangkok to Budapest.

13 The third phase ended in 2009 with the onset of the financial crisis and global recession. We are once again at an inflexion point, but with no clarity on the paradigm going forward. The crisis has revealed significant imperfections in market mechanisms: information asymmetry, moral hazard, systemic risks, and behavioural or non-rational motivators of choice. It has also revealed the inherent limitations of government: in a globalised and complex economy, governments have fewer levers to pull, and these levers are less potent than before. Neither market fundamentalism nor central planning has worked.

A Singapore Consensus?

14 As we look for a new paradigm, each country will have to find its own balance between markets and government. Indeed, there may well be no universal paradigm that applies at all times and in all places. The balance between markets and government may have to be calibrated and re-calibrated continually, adapting to circumstance and context. Indeed this has been the central insight of Singapore's development experience.

15 Singapore's approach to policymaking is not easily contained in any of the "isms" beloved of intellectuals. The two "isms" that perhaps best describe Singapore's approach are: **pragmatism** – an emphasis on what works in practice rather than abstract theory; and **eclecticism** – a willingness to adapt to the local context best practices from around the world.

16 The ideological conflicts over the role of governments vis-a-vis markets often present a false choice. Public policy in Singapore, on the other hand, has been guided by a deep appreciation of the critical interdependence between markets and government. Indeed, Singapore's approach can be summed up as: *governments need markets and markets need government.*

17 First, **governments need markets**. That the market plays a central role in Singapore is well-known. According to the World Bank, Singapore is the easiest place in the world to do business. According to the Heritage Foundation, Singapore is the freest economy in the world, after Hong Kong. There are virtually no import tariffs, no export subsidies, no exchange restrictions, no price ceilings, no minimum wage, no rent control. Income tax rates are among the lowest in the world, and government expenditure as a percentage of GDP well below most countries.

18 Equally, if not more importantly, government policies have been strongly guided by the application of market principles. Be it in industrial policy, medical insurance, congestion pricing, social security, regulation of utilities, or allocation of land, Singapore has assiduously applied market mechanisms and price signals. “*Getting the economics right*” has been a hallmark of governance.

19 Second, **markets need governments**. Economic development does not occur naturally. It needs pre-conditions, and if these do not exist, government needs to create them. Markets function best under some rather exacting conditions – rule of law, perfect information, absence of co-ordination failures, and no monopoly power. But the irony is that governments sometimes have to be in markets to enable these conditions.

20 This is where free marketers are disenchanted with Singapore – the government has never hesitated from guiding the development process or intervening in markets where it believes such intervention will lead to superior outcomes.

21 The objective of government intervention in Singapore is neither to suppress nor to supplant markets, but to support and sustain them. Government intervention has sought to harness the power of the market to manage and grow the economy. Reasonable people have argued – and quite rightly so - that not all

of the Singapore government's interventions have worked. But that is a reason to scale back, modify or even withdraw the intervention, not to reject the role of government altogether.

22 Adapting from a framework first proposed by Dani Rodrik to describe the role of institutions, let me illustrate how government in Singapore has intervened to try to make markets work better, in four key respects.

- First, the government has sought to **enable markets**. This includes ensuring rule of law, property rights, and public infrastructure – functions that most governments perform. But in Singapore, enabling markets has also included industrial policy and capability development, subjects of continuing controversy in policy circles around the world.
- Second, the government has sought to **regulate markets**. This includes supervision of the financial sector, competition regulation, and taxation of negative externalities. A key feature of Singapore's approach has been the shift towards lighter regulation accompanied by risk-based supervision.
- Third, the government has sought to **stabilise markets**. This is the bread-and-butter of macroeconomic management. Singapore's basic approach in monetary and fiscal policy is not far from global practices. But its efforts to address asset price inflation and credit crises are interesting examples of targeted interventions that harness market forces.

- Fourth, the government has sought to **legitimise markets**. Globalisation, free trade, and open markets lead to significant dislocations. Some of the sharpest debates over the role of governments centre on this: to what extent should governments facilitate adjustments, redistribute incomes, or provide social safety nets, so as to maintain public support for market-oriented policies? Singapore has sought to find its own middle ground on this complex challenge.

23 Let me now illustrate each of these four dimensions of government involvement in markets, with a specific example from Singapore's experience.

Enabling Markets - Singapore's Industrial Policy

24 First, enabling markets. Singapore's industrial policy makes a good case for how judicious government intervention has enabled the market to spur structural transformation and growth. Academic opinion over the merits of industrial policy is sharply divided. Many economists are deeply sceptical about government's ability to "*pick winners*" – and for good reason. Despite the best of intentions, industrial policy in many countries has degenerated into corruption and rent-seeking. As Dani Rodrik and Ricardo Hausmann put it "*the proverbial road to hell is paved with well-meaning industrial development plans.*"

25 Michael Porter says, "*national prosperity is created, not inherited.*" That is in a sense the starting point of Singapore's industrial policy: to create an enabling environment for the growth of new *clusters* – agglomerations of related firms, industries, and institutions that derive synergies from one another.

26 So, it is not simply a case of "picking winners". Rather, the government has focused on addressing **market failures** that stand in the way of cluster development. According to Dani Rodrik and Ricardo Hausmann, the process of structural transformation in an economy is unlikely to take place under *laissez-*

faire conditions because of market imperfections. They argue that government action is often necessary to overcome these imperfections and foster the development of industry. (I look forward to Jesus Felipe expounding on this further later today)

27 One common imperfection is **co-ordination failure**. The demand for a particular activity often depends on whether other complementary activities are already in place. This requires some form of central co-ordination. For example, hotels will be built next to a beautiful beach resort only if there is an airport and roads to bring tourists to the resort.

28 The growth of Singapore's chemicals cluster illustrates this well. Singapore had managed, in the 1960s and 1970s, to grow a viable petroleum refining industry despite having no oil and gas of its own. The next step was to move up the value chain to petrochemicals. The 1980s saw a global boom in petrochemicals and an unprecedented wave of investments into Asia. But competition from low-cost locations was keen. To overcome Singapore's cost disadvantage and grow a viable chemicals cluster, it was necessary to move 'downstream' to the production of higher value-added specialty chemicals. But such an integrated development would require much land – which Singapore was obviously short of.

29 The Economic Development Board, or EDB, hatched an innovative plan to reclaim and amalgamate seven islands in the south-western part of Singapore, where the existing oil refineries were located. The Jurong Town Corporation, or JTC, led the government effort to create an integrated "chemicals island" – Jurong Island.

30 In the years that followed, company after company came to Jurong Island: a "who's who" of the global chemical industry - Chevron, Sumitomo, Mitsui, Exxon, Shell, and others. By the time Jurong Island officially opened in October 2000,

over 60 leading petrochemical related companies had invested more than \$20 billion on the island.

31 The government's activist role in the petrochemical industry helped address several coordination failures in the market, something which no single private company could have easily resolved. The key to Jurong Island's success was not infrastructure per se, but *government-enabled industry integration*. Companies came together in one location, supported by common pipeline corridors and a fully integrated logistics hub. They could buy and sell their products and services from one another "*across the fence*". Upstream refineries could sell feedstock to downstream manufacturers. Horizontal linkages allowed different plants to outsource and share common services such as warehousing and waste treatment. Companies were able to reduce operating costs, enjoy economies of scale, and focus on their core operations.

32 Another source of market failure that Singapore's industrial policy has sought to address is ***information and learning spill-overs***. Firms under-invest in economic activities where the private returns to these investments are lower than their social benefits. The government provided firms the incentive to invest in higher value-added activities while building the capabilities of the workforce to undertake these activities. This has helped to diversify production towards sectors with faster growing demand and higher spillover effects on the rest of the economy.

33 Take for example the growth of the electronics cluster – the lynchpin of Singapore's industrialisation. The engineering and technical capabilities associated with the electronics industry are highly transferable. The industry itself is not static, continually upgrading, innovating, and developing new products. It has large spillover benefits.

34 Singapore's electronics industry began in the 1960s with the packaging of semiconductors. The government awarded pioneer status tax incentives to multinational semiconductor companies, like General Electric and Texas Instruments, to set up assembly plants in Singapore. These operations spearheaded Singapore's industrialisation and created many jobs.

35 If the story had ended there, Singapore's industrial policy would have been quite unremarkable. In the 1970s, Singapore started to lose competitiveness in labour-intensive activities like semiconductor assembly. Instead of trying to protect these activities, the government allowed them to be phased out. Then Minister for Finance, Goh Keng Swee, the architect of Singapore's economy who shaped Singapore's approach of combining markets and government, took a cold, rational approach. He famously characterised semiconductor assembly operations as employing workers who were "*less skilled than barbers*". Goh Keng Swee told EDB that he would no longer approve pioneer status tax incentives for semiconductor assembly operations. Singapore was forced to move up the technology ladder.

36 At this time, Seagate was looking for a low-cost location in Asia to manufacture hard-disk drives. EDB collected quotations from small and medium enterprises based in Singapore to convince Seagate that Singapore could provide the necessary components at a lower cost. Thus began disk-drive manufacturing in Singapore, which soon became the world's largest producer of Winchester hard disk drives.

37 The same thing happened in the 1980s and 1990s. As the hard disk drive industry came under competitive pressure, the government started to create the market conditions to woo computer manufacturers. After all, personal computers had higher margins and value-added than television sets. Singapore also went into hard disk media and wafer fabrication of microchips.

38 The capabilities built up in electronics have positioned Singapore well for the industrial clusters of tomorrow, such as clean technology and medical devices. The manufacturing of solar wafers, cells, and modules draws on skills developed in semiconductor wafer fabrication. Likewise, engineering capabilities built up in making precision electronics devices are relevant to making sophisticated medical devices.

39 Besides a focus on overcoming market failures, a distinguishing feature of Singapore's industrial policy is its strict adherence to **market principles**. The government has never subsidised the running costs of firms. There are no protective barriers. There are no bailouts. The market, not government, decides whether a company is viable. Many firms have gone under; many others have relocated from Singapore to more cost-competitive locations. As Ricardo Hausmann puts it, "*What distinguishes a good industrial policy is not the ability to pick winners, but the guts to let losers go.*" Goh Keng Swee would have agreed heartily.

Regulating Markets – Supervising the Financial Sector

40 From enabling markets, let me move now to government's role in regulating markets. And in the aftermath of the recent crisis, it is the regulation of the financial sector that is of greatest interest.

41 Stability is fundamental to a well-functioning financial system. But this stability does not occur naturally. While financial markets are generally efficient, they are subject to market failure and occasional bouts of instability. (Andrew Sheng knows the subject well and will tell us more about it.)

42 Take the recent financial crisis for example. Moral hazard occurs when those who make loans are not the ones who bear the risk of default – or at least, they *thought* they did not bear the risk. Information asymmetry occurs when debt instruments are packaged into complex products whose risks investors do not

understand. When risk is neither monitored nor understood, it gets under-priced and builds up in the system. Effective regulation and supervision of the financial sector is therefore critical to promote prudent behaviour and sound risk management. The question is: how to do it without stifling the market? There are no easy answers.

43 The Monetary Authority of Singapore, or MAS, tries to do this in three ways. First, it sets healthy prudential standards. Second, it takes a risk-focused approach to supervision. Third, it leverages on the market by relying on stakeholders to complement official oversight.

44 First, **healthy prudential standards**. MAS has consistently emphasised healthy prudential standards, especially in good times. Many of these are above international norms:

- Banks keep a minimum 10% capital adequacy ratio, with at least 6% in Tier 1 capital.
- Banks set aside general impairment provisions of not less than 1% of net loans and receivables, so that cushions are built up ahead of loan losses.
- Housing loans are subject to an 80% loan-to-value limit. In other words, a lender has at least a 20% buffer against a reduction in collateral value.

45 These buffers have served Singapore well, allowing its financial institutions to ride out successive regional and global financial market stresses.

46 Second, ***risk-focused supervision***. The crisis has highlighted the importance of getting the supervisory approach and intensity right. MAS evaluates the relative risk posed by each financial institution. It subjects the financial institution that potentially has the largest impact on the financial system, to the greatest supervisory intensity.

47 MAS demands substantial information and data from financial institutions to review their financial situation and their risk profile. Rather than having a fixed view of what is an acceptable level of business risk, MAS assesses this against the institution's risk management standards. Institutions engaging in complex financial businesses must be able to demonstrate that their risk management capabilities match their risk profiles. A risk-focused approach allows greater business latitude for well-managed institutions while retaining higher prudential requirements or tighter restrictions for weaker ones.

48 Third, ***relying on stakeholders***. Primary responsibility for the safety and soundness of a financial institution must lie with its board of directors and senior management. It is their job to maintain adequate risk oversight of the institution's business activities. It is neither feasible nor desirable for the regulator to do this.

49 The government also leverages on market discipline to foster prudent behaviour among financial institutions. There are stakeholders such as shareholders, creditors, and counterparties who have an interest in the continued financial health of the institution. Likewise, professionals such as rating agencies and external auditors provide an independent assessment of the risks inherent in the institution and the adequacy of internal controls.

50 Of course, as the recent financial crisis has shown, stakeholder governance and market discipline can fail quite spectacularly. Herd behaviour and irrational exuberance can lead the market to overvalue assets or underestimate risks. This is why regulation remains necessary and important. But it would be a mistake to

substitute tighter regulation for stakeholder governance and market discipline. Rather, governments should examine how to better align market forces and private incentives with regulatory objectives. A stable financial system is better assured with a combination of robust regulation, prudent corporate governance, and effective market discipline.

Stabilising Markets - Dealing with a Credit Crisis

51 The third key role of governments in markets is stabilisation. While it has been convenient to blame governments for not preventing the financial crisis, let us not forget that it was action by governments around the world that prevented a complete meltdown of markets. Let me share Singapore's experience in fighting the credit crisis.

52 When the financial crisis broke out in September 2008 in the United States, the ripple effects were felt throughout the world. A systemic seizure of credit was underway and threatened to have dire spill-over effects on the real economy if the situation was not stabilised. Trade financing dried up significantly, impacting Singapore's exporters and offshore trading companies.

53 This was not an issue for monetary policy. Heightened risk aversion had effectively broken the transmission mechanism from liquidity to credit. The problem had to be attacked at its source – the unwillingness of banks to extend credit. Coercing the banks to lend would have been prudentially irresponsible. Government stepping in to lend directly would have put taxpayers' monies at too much risk.

54 The Ministry of Trade and Industry (MTI) and the Ministry of Finance (MOF) got together to analyse the situation. The market failure was at two levels: the supply of credit and the price of credit. For some sectors and geographies, there was an unwillingness to provide trade financing or working capital at any interest rate. For other kinds of loans or borrowers, banks were willing to lend but at much

higher interest rates. MTI and MOF decided that the way out of the logjam was for the government to underwrite a sufficiently large share of the default risk so that banks are induced to lend.

55 But how to do this without moral hazard? The fear that gripped MTI and MOF officials was that government would end up with “lemons”. Will banks push the less credit-worthy loans to the government and focus on the safer credits? Will government end up losing a lot of money without improving the access to credit for deserving firms?

56 Thus, in all the credit schemes that were drawn up, the principle that government must harness the power of the market was strictly applied. The government was seeking not to replace the lending market but to complement it.

57 First, the government refrained from direct lending. Assessing credit risk was not a civil servant’s area of expertise. All government facilitated loans were made through financial intermediaries, to tap on their expertise in risk assessment.

58 Second, despite strong pressures from both banks and the industry, the government refrained from taking on 100% of the risk on any loan. For every subsidised loan, the bank assessing the loan had to have “skin in the game”. For unsecured working capital loans, the government bore 80% of the risk, for micro loans to start-ups, the risk-share went up to 90%; but in no instance, did it go to 100%. There were suggestions for government to underwrite the risk on a portfolio basis rather than a per loan basis. The government did not agree. It was important that the bank had something to lose in every loan.

59 The credit enhancement schemes worked. They catalysed more than 14,000 loans worth about \$8 billion between December 2008 and January 2010. What is even more remarkable is that the ratio of non-performing loans under the

credit enhancement schemes was at an acceptable level despite the severity of the financial crisis.

60 When credit conditions had recovered sufficiently by early 2010, the government scaled back the credit enhancement schemes, reducing loan quantum and the risk-share. This let the market revert to normalcy, so that risk would not be mispriced over the longer term. Knowing when and how to exit is an important consideration in any government intervention.

Legitimising Markets - Social Inclusion

61 Enabling, regulating, and stabilising markets is not enough. To ensure continued public support and thereby the sustainability of the market system, the government has to play an additional role - legitimise markets. Income inequality is a problem. (Richard Wilkinson will explain to us later how unequal societies do worse than more equal societies on a range of social indicators.)

62 It is sometimes said that Western economies adopted the welfare state, to save capitalism from itself. There is some truth to this. But this model is now under pressure from rising expectations and ageing populations. Globalisation has added a new twist to this challenge. Free trade and open markets are being blamed for widening income inequality and median wage stagnation. Hence, the rise in protectionism and xenophobia in many parts of the world.

63 Singapore has always subscribed to the principle of social inclusion. But the experience of other countries has given Singapore much reason to be cautious in the design of its social safety nets. The growth of the welfare state has been associated with an eroding work ethic, a deteriorating fiscal position, and a growing entitlement mentality. If there is another path to hell besides the one paved with failed industrial policies (which I had mentioned earlier), it must be the one paved with failed welfare policies!

64 Self-reliance is the basis for a healthy work ethic; it drives private initiative and enterprise. How does Singapore foster social inclusion while safeguarding the culture of self-reliance?

65 First, it provides massive subsidies for **education**. It is well known that education promotes social mobility. But in many parts of the world, this has not been the case because there are wide differences in educational opportunities that depend on socio-economic status. Singapore has invested heavily in ensuring a high quality of education across the spectrum and made it highly affordable for all income groups. This is perhaps why the premium in test scores that Singapore students enjoy over students from other countries is *widest* for those in the bottom half of the education system. This is not to suggest that starting positions do not matter in Singapore. They do. But they matter less because of the levelling effect of education.

66 Second, the government has intervened substantially in making **home ownership** affordable for the vast majority of the population. Low-income families get a housing grant to purchase public housing flats, which are subsidised to begin with and come with a subsidised loan. Housing is an appreciating asset that promotes social mobility, financial security, and a sense of pride and belonging.

67 Third, the government provides a **wage supplement** to low-income workers. Faced with growing income inequality, Singapore has adopted a *Workfare* model instead of a *Welfare* model. Under a traditional *Welfare* approach, the state insures citizens against a wide range of risks, especially unemployment and illness. But under a *Workfare* approach, benefits are targeted at low-wage workers. Tying government transfers to work avoids the moral hazard problems associated with unconditional transfers to the poor. Workfare redistributes incomes, while preserving the work ethic and promoting self-reliance. It covers nearly 20% of the workforce, providing wage supplements of up to 20% of the incomes of low-wage, older workers.

68 But no government intervention is without distortion. It has been argued that Singapore's social safety net system is perhaps too heavily biased towards housing and that this comes at the expense of cash savings for retirement. Workfare payments may have contributed to reduced productivity by retaining in the workforce more lower-skilled workers than might have been the case. There has also been criticism that Singapore's social safety nets are not sufficient – especially for the disabled, the aged destitute, the unemployable. We must continually seek incentive-compatible solutions to these problems, bearing in mind the risk of unintended consequences. Social inclusion policies have to be continually recalibrated, to minimise distortions while maximising opportunities for the less fortunate in our societies.

Conclusion

69 Let me conclude. The crisis has shaken our confidence in both markets and governments. But mistakes and failures are bound to occur. They occur not because market participants are greedy or government officials incompetent. They occur because the world we live in is fundamentally complex and uncertain. Both markets and governments have been found wanting. What we need is not more of one and less of the other. We need both to be more effective and to work in closer collaboration, so that public interest and private initiative are better aligned. As Amartya Sen puts it: *“The invisible hand of the market has often relied on the visible hand of government.”*

70 Singapore's experience is that market principles are necessary to help government work better, and that good government is necessary to help markets work better. This is not to suggest that Singapore has got the balance right. Far from it. Singapore is still an experiment, a work-in-progress. If anything, the key take-away from the Singapore story is to keep an open mind, measure outcomes, continually review policies, and learn from mistakes. Pragmatism and experimentation must become the watchwords in public policy.

71 The choice is not between big government and small government. It is about creating *effective government*. What matters is what governments do, not how big they are. The *size* of governments may well have to shrink – the revenue base in most countries will be capped by competition and demographics. But the *responsibilities* of government may well have to expand – to enable, regulate, stabilise, and legitimise markets so that they can work better. Getting the balance right between markets and government will be key to improving the standard of living and welfare of our fellow citizens.

72 I have quoted during my speech several economists, the so-called worldly philosophers. Let me close by drawing on the wisdom from an *other-worldly* philosopher. If we could adapt to our context, the Serenity Prayer attributed to Reinhold Niebuhr, we would say, “*Governments need the capability to step in where they can make markets work better, the humility to get out of the way when they are likely to make matters worse, and most of all, the wisdom to know the difference.*”

73 Thank you for your attention.