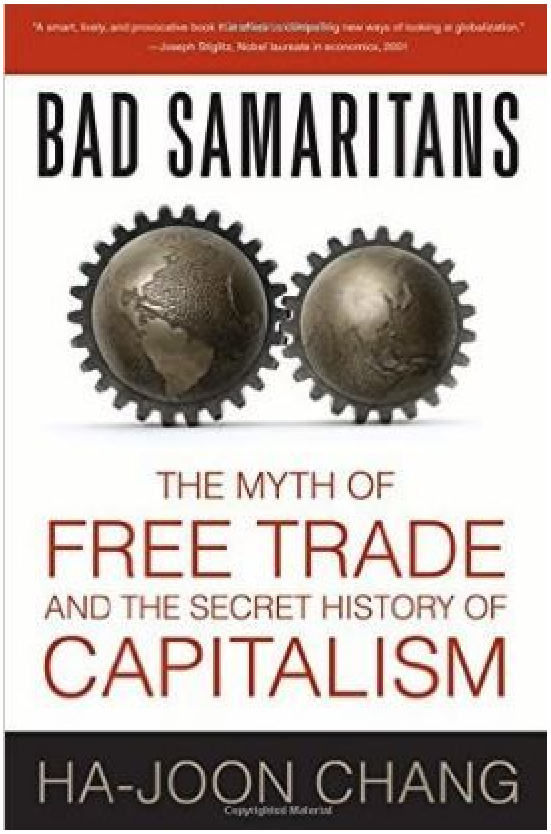

To Hee-Jeong

Bad Samaritans

The Myth of Free Trade
and the Secret History
of Capitalism

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Tres Estrelas announces a new breakthrough in fuel cell technology

In a carefully staged event to coincide with the country's independence day on June 25th, Maputo-based Tres Estrelas, the largest African business group outside South Africa, unveiled a breakthrough technology for mass production of hydrogen fuel cells. 'When our new plant goes into production in the autumn of 2063, ' Mr Armando Nhumaio, the ebullient chairman of the company announced, 'we will be able to take on the big boys from Japan and the USA by offering consumers much better value for money.' Analysts agree that the new technology from Tres Estrelas means hydrogen fuel is set to replace alcohol as the main source of power for automobiles. 'This is bound to pose a serious challenge to the leading alcohol fuel producers, like Petrobras of Brazil and Alconas of Malaysia, ' says Nelson Mbeki-Malan, the head of the prestigious Energy

Economics Research Institute at the University of Western Cape, South Africa.

Tres Estrelas has made its own rocket-fuelled journey from humble beginnings. The company started out exporting cashew nuts in 1968, seven years before Mozambique's independence from the Portuguese. It then did well by diversifying into textiles and sugar refining. Subsequently, it made a bolder move into electronics, first as a subcontractor for the Korean electronics giant, Samsung, and later as an independent producer. But an announcement in 2030 that hydrogen fuel cell production was to be its next venture generated considerable scepticism. 'Everyone thought we were crazy, ' says Mr Nhumaio. 'The fuel cell division bled money for 17 years. Luckily, in those days, we did not have many outside shareholders requiring instant results.We persisted in our belief that building a world-class firm requires a long period of preparation.'

The company's rise symbolizes the economic miracle that is modern Mozambique. In 1995, three years after the end of its bloody 16-year civil war, Mozambique had a *per capita* income of only $80 and was literally the poorest economy in the world. With deep political divisions, rampant corruption and a sorry 33% literacy rate, its prospects ranged from dire to grim. In 2000, eight years after the end of the civil war, the average Mozambican still earned only $210 a year, just over half that of the average Ghanaian, who was earning $350. However, since then, Mozambique's economic miracle has transformed it into one of the richest economies in Africa and a solid upper-middle-income country. With a bit of luck and sweat, it may even be able to join the ranks of the advanced economies in the next two or three decades.

'We will not rest on our laurels, ' says Mr Nhumaio, whose roguish grin is reported to hide a steely determination.'This is a tough industry where technology changes fast. Product life-cycles are short and no one can expect to last long as the market leader based on only one innovation. Competitors may appear on the horizon out of nowhere any day.' After all, his company has just sprung a nasty surprise on the Americans and the Japanese. Might a relatively unknown fuel cell manufacturer somewhere in Nigeria decide that, if Tres Estrelas was able to move from the darkest shadows to the top of the tree, then perhaps it could too?

Mozambique may or may not succeed in living up to my fantasy. But what would your reaction have been, had you been told in 1961, a century before the Mozambican dream, that South Korea would, in 40 years' time, be one of the world's leading exporters of mobile phones, a strictly science-fiction product at that time? Hydrogen fuel cells do at least exist today.

In 1961, eight years after the end of its fratricidal war with North Korea, South Korea's yearly income stood at $82 per person. The average Korean earned *less than half* the average Ghanaian citizen ($179).[1] The Korean War – which, incidentally, started on June 25, Mozambique's independence day – was one of the bloodiest in human history, claiming four million lives

in just over three years (1950–3). Half of South Korea's manufacturing base and more than 75% of its railways were destroyed in the conflict. The country had shown some organizational ability by managing to raise its literacy ratio to 71% by 1961 from the paltry 22% level it had inherited in 1945 from its Japanese colonial masters, who had ruled Korea since 1910. But it was widely considered a basket case of developmental failure. A 1950s internal report from USAID – the main US government aid agency then, as now – called Korea a 'bottomless pit'. At the time, the country's main exports were tungsten, fish and other primary commodities.

As for Samsung, [*] now one of the world's leading exporters of mobile phones, semiconductors and computers, the company started out as an exporter of fish, vegetables and fruit in 1938, seven years before Korea's independence from Japanese colonial rule. Until the 1970s, its main lines of business were sugar refining and textiles that it had set up in the mid-1950s.[2] When it moved into the semiconductor industry by acquiring a 50% stake in Korea Semiconductor in 1974, no one took it seriously. After all, Samsung did not even manufacture colour TV sets until 1977. When it declared its intention, in 1983, to take on the big boys of the semiconductor industry from the US and Japan by designing its own chips, few were convinced.

Korea, one of the poorest places in the world, was the sorry country I was born into on October 7 1963. Today I am a citizen of one of the wealthier, if not wealthiest, countries in the world. During my lifetime, *per capita* income in Korea has grown something like 14 times, in purchasing power terms. It took the UK over two centuries (between the late 18th century and today) and the US around one and half centuries (the 1860s to the present day) to achieve the same result.[3]

The material progress I have seen in my 40-odd years is as though I had started life as a British pensioner born when George III was on the throne or as an American grandfather born while Abraham Lincoln was president.

The house I was born and lived in until I was six was in what was then the north-western edge of Seoul, Korea's capital city. It was one of the small (two-bedroom) but modern homes that the government built with foreign aid in a programme to upgrade the country's dilapidated housing stock. It was made with cement bricks and was poorly heated, so it was rather cold in winter – the temperature in Korea's winter can sink to 15 or even 20 degrees below zero. There was no flushing toilet, of course: that was only for the very rich.

Yet my family had some great luxuries that many others lacked, thanks to my father, an elite civil servant in the Finance Ministry who had diligently saved his scholarship money while studying at Harvard for a year. We owned a black-and-white TV set, which exerted a magnetic pull on our neighbours. One family friend, an up-and-coming young dentist at St Mary's, one of the biggest hospitals in the country, somehow used to find the time to visit us whenever there was a big sports match on TV – ostensibly for reasons totally unrelated to the match. In today's Korea, he would be contemplating upgrading the second family TV in the bedroom to a plasma screen. A cousin of mine who had just moved from my father's native city of Kwangju to Seoul came to visit on one occasion and quizzed my mother about the strange white cabinet in the living room. It was our refrigerator (the kitchen being too small to accommodate it).My wife, Hee-Jeong, born in Kwangju in 1966, tells me that her neighbours would regularly 'deposit' their precious meat in the refrigerator of her mother, the wife of a prosperous

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doctor, as if she were the manager of an exclusive Swiss private bank.

A small cement-brick house with a black-and-white TV and a refrigerator may not sound much, but it was a dream come true for my parents' generation, who had lived through the most turbulent and deprived times: Japanese colonial rule (1910–45), the Second World War, the division of the country into North and South Korea (1948) and the Korean War. Whenever I and my sister, Yonhee, and brother, Hasok, complained about food, my mother would tell us how spoilt we were. She would remind us that, when they were our age, people of her generation would count themselves lucky if they had an egg. Many families could not afford them; even those who could reserved them for fathers and working older brothers. She used to recall her heartbreak when her little brother, starving during the Korean War at the age of five, said that he would feel better if he could only hold a rice bowl in his hands, even if it was empty. For his part, my father, a man with a healthy appetite who loves his beef, had to survive as a secondary school student during the Korean War on little more than rice, black-market margarine from the US army, soy sauce and chilli paste. At the age of ten, he had to watch helplessly as his seven-year-old younger brother died of dysentery, a killer disease then that is all but unknown in Korea today.

Years later, in 2003, when I was on leave from Cambridge and staying in Korea, I was showing my friend and mentor, Joseph Stiglitz, the Nobel Laureate economist, around the National Museum in Seoul. We came across an exhibition of beautiful black-and-white photographs showing people going about their business in Seoul's middle-class neighbourhoods during the late 1950s and the early 1960s. It was exactly how I remembered my childhood. Standing behind me and

Joe were two young women in their early twenties. One screamed, 'How can that be Korea? It looks like Vietnam!' There was less than 20 years' age gap between us, but scenes that were familiar to me were totally alien to her. I turned to Joe and told him how 'privileged' I was as a development economist to have lived through such a change. I felt like an historian of mediaeval England who has actually witnessed the Battle of Hastings or an astronomer who has voyaged back in time to the Big Bang.

Our next family house, where I lived between 1969 and 1981, at the height of Korean economic miracle, not only had a flushing toilet but also boasted a central heating system. The boiler, unfortunately, caught fire soon after we moved in and almost burned the house down. I don't tell you this in complaint; we were lucky to have one – most houses were heated with coal briquettes, which killed thousands of people every winter with carbon monoxide poisoning. But the story does offer an insight into the state of Korean technology in that far-off, yet really so recent, era.

In 1970 I started primary school. It was a second-rate private school that had 65 children in each class. We were very proud because the state school next door had 90 children per class.Years later, in a seminar at Cambridge, a speaker said that because of budget cuts imposed by the International Monetary Fund (more on this later), the average number of pupils per classroom in several African countries rose from 30-something to 40-something in the 1980s. Then it hit me just how bad things had been in the Korean schools of my childhood.When I was in primary school, the poshest school in the country had 40 children in a class, and everyone wondered, 'how do they do that?' State schools in some rapidly expanding urban areas were stretched to the limit, with up to 100 pupils per class

and teachers running double, sometimes triple, shifts. Given the conditions, it was little wonder that education involved beating the children liberally and teaching everything by rote. The method has obvious drawbacks, but at least Korea has managed to provide at least six years' education to virtually every child since the 1960s.

In 1972, when I was in Year 3 (US third grade), my school playground suddenly became a campsite for soldiers. They were there to pre-empt any student demonstrations against the martial law being imposed by the president of the country, (former) General Park Chung-Hee. Thankfully, they were not there to take on me and my friends. We Korean kids may be known for our academic precocity, but constitutional politics were frankly a little bit beyond us nine-year-olds.My primary school was attached to a university, whose rebellious students were the soldiers' target. Indeed, Korean university students were the nation's conscience throughout the political dark age of the military dictatorship and they also played the leading role in putting an end to it in 1987.

After he had come to power in a military coup in 1961, General Park turned 'civilian' and won three successive elections. His electoral victories were propelled by his success in launching the country's economic 'miracle' through his Five Year Plans for Economic Development. But the victories were also ensured by election rigging and political dirty tricks. His third and supposedly final term as president was due to end in 1974, but Park just could not let go.Halfway through his third term, he staged what Latin Americans call an 'auto-coup'. This involved dissolving the parliament and establishing a rigged electoral system to guarantee him the presidency for life. His excuse was that the country could ill afford the chaos of democracy. It had to defend itself against North Korean communism, the people were told, and accelerate its economic development. His proclaimed goal of raising the country's *per capita* income to 1, 000 US dollars by 1981 was considered overly ambitious, bordering on delusional.

President Park launched the ambitious Heavy and Chemical Industrialization (HCI) programme in 1973. The first steel mill and the first modern shipyard went into production, and the first locally designed cars (made mostly from imported parts) rolled off the production lines. New firms were set up in electronics, machinery, chemicals and other advanced industries. During this period, the country's *per capita* income grew phenomenally by more than five times, in US dollar terms, between 1972 and 1979. Park's apparently delusional goal of $1, 000 *per capita* income by 1981 was actually achieved four years ahead of schedule. Exports grew even faster, increasing nine times, in US dollar terms, between 1972 and 1979.[4]

The country's obsession with economic development was fully reflected in our education. We learned that it was our patriotic duty to report anyone seen smoking foreign cigarettes. The country needed to use every bit of the foreign exchange earned from its exports in order to import machines and other inputs to develop better industries. Valuable foreign currencies were really the blood and sweat of our 'industrial soldiers' fighting the export war in the country's factories. Those squandering them on frivolous things, like illegal foreign cigarettes, were 'traitors'. I don't believe any of my friends actually went as far as reporting such 'acts of treason'. But it did feed the gossip mill when kids saw foreign cigarettes in a friend's house. The friend's father – it was almost invariably men who smoked – would be darkly commented on as an unpatriotic and therefore

immoral, if not exactly criminal, individual.

Spending foreign exchange on anything not essential for industrial development was prohibited or strongly discouraged through import bans, high tariffs and excise taxes (which were called luxury consumption taxes). 'Luxury' items included even relatively simple things, like small cars, whisky or cookies. I remember the minor national euphoria when a consignment of Danish cookies was imported under special government permission in the late 1970s. For the same reason, foreign travel was banned unless you had explicit government permission to do business or study abroad. As a result, despite having quite a few relatives living in the US, I had never been outside Korea until I travelled to Cambridge at the age of 23 to start as a graduate student there in 1986.

This is not to say that no one smoked foreign cigarettes or ate illicit cookies. A considerable quantity of illegal and semi-legal foreign goods was in circulation. There was some smuggling, especially from Japan, but most of the goods involved were things brought in – illegally or semi-legally – from the numerous American army bases in the country. Those American soldiers who fought in the Korean War may still remember malnourished Korean children running after them begging for chewing gum or chocolates.Even in the Korea of the 1970s, American army goods were still considered luxuries. Increasingly affluent middle class families could afford to buy M&M chocolates and Tang juice powders from shops and itinerant pedlars. Less affluent people might go to restaurants that served *boodae chige*, literally 'army base stew'. This was a cheaper version of the classic Korean stew, *kimchee chige*, using *kimchee* (cabbages pickled in garlic and chilli) but substituting the other key ingredient, pork belly, with cheaper meats, like surplus bacon, sausages and spam smuggled out of American army bases.

I longed for the chance to sample the tins of spam, corned beef, chocolates, biscuits and countless other things whose names I did not even know, from the boxes of the American Army's 'C Ration' (the canned and dried food ration for the battlefield). A maternal uncle, who was a general in the Korean army, used to accumulate supplies during joint field exercises with his American colleagues and gave them to me as an occasional treat. American soldiers cursed the wretched quality of their field rations. For me they were like a Fortnum & Mason picnic hamper. But, then, I was living in a country where vanilla ice cream had so little vanilla in it that I thought vanilla meant 'no flavour', until I learnt English in secondary school. If that was the case with a well-fed upper-middle-class child like me, you can imagine what it must have been like for the rest.

When I went to secondary school, my father gave me a Casio electronic calculator, a gift beyond my wildest dreams. Then it was probably worth half a month's wages for a garment factory worker, and was a huge expense even for my father, who spared nothing on our education. Some 20 years later, a combination of rapid development in electronics technologies and the rise in Korea's living standards meant that electronic calculators were so abundant that they were given out as free gifts in department stores. Many of them ended up as toys for toddlers (no, I don't believe this is why Korean kids are good at maths!).

Korea's economic 'miracle' was not, of course, without its dark sides. Many girls from poor families in the countryside were forced to find a job as soon as they left primary school at the age of 12 – to 'get rid of an extra mouth' and to earn money so that at least one brother could receive higher education.Many ended up

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as housemaids in urban middle-class families, working for room and board and, if they were lucky, a tiny amount of pocket money. The other girls, and the less fortunate boys, were exploited in factories where conditions were reminiscent of 19th-century 'dark satanic mills' or today's sweatshops in China. In the textile and garment industries, which were the main export industries, workers often worked 12 hours or more in very hazardous and unhealthy conditions for low pay. Some factories refused to serve soup in the canteen, lest the workers should require an extra toilet break that might wipe out their wafer-thin profit margins. Conditions were better in the newly emerging heavy industries – cars, steel, chemicals, machinery and so on – but, overall, Korean workers, with their average 53–4 hour working week, put in longer hours than just about anyone else in the world at the time.

Urban slums emerged. Because they were usually up in the low mountains that comprise a great deal of the Korean landscape, they were nicknamed 'Moon Neighbourhoods', after a popular TV sitcom series of the 1970s. Families of five or six would be squashed into a tiny room and hundreds of people would share one toilet and a single standpipe for running water. Many of these slums would ultimately be cleared forcefully by the police and the residents dumped in far-flung neighbourhoods, with even worse sanitation and poorer road access, to make way for new apartment blocks for the ever-growing middle class. If the poor could not get out of the new slums fast enough (though getting out of the slums was at least possible, given the rapid growth of the economy and the creation of new jobs), the urban sprawl would catch up with them and see them rounded up once again and dumped in an even more remote place. Some people ended up scavenging in the city's main rubbish dump, Nanji

Island. Few people outside Korea were aware that the beautiful public parks surrounding the impressive Seoul Football Stadium they saw during the 2002 World Cup were built literally on top of the old rubbish dump on the island (which nowadays has an ultra-modern eco-friendly methane-burning power station, which taps into the organic material dumped there).

In October 1979, when I was still a secondary school student, President Park was unexpectedly assassinated by the chief of his own Intelligence Service, amid mounting popular discontent with his dictatorship and the economic turmoil following the Second Oil Shock. A brief 'Spring of Seoul' followed, with hopes of democracy welling up. But it was brutally ended by the next military government of General Chun Doo-Hwan, which seized power after the two-week armed popular uprising that was crushed in the Kwangju Massacre of May 1980.

Despite this grave political setback, by the early 1980s, Korea had become a solid middle-income country, on a par with Ecuador, Mauritius and Costa Rica. But it was still far removed from the prosperous nation we know today. One of the slang expressions common among us high-school students was 'I've been to Hong Kong', which meant 'I have had an experience out of this world'. Even today, Hong Kong is still considerably richer than Korea, but the expression reflects the fact that, in the 1960s or the 1970s, Hong Kong's *per capita* income was three to four times greater than my country's.

When I went to university in 1982, I became interested in the issue of intellectual property rights, something that is even more hotly debated today. By that time, Korea had become competent enough to copy advanced products and rich enough to want the finer things in life (music, fashion goods, books). But it was

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still not sophisticated enough to come up with original ideas and to develop and own international patents, copyrights and trademarks.

Today, Korea is one of the most 'inventive' nations in the world – it ranks among the top five nations in terms of the number of patents granted annually by the US Patent Office. But until the mid-1980s it lived on 'reverse engineering'. My friends would buy 'copy' computers that were made by small workshops, which would take apart IBM machines, copy the parts, and put them together. It was the same with trademarks. At the time, the country was one of the 'pirate capitals' of the world, churning out fake Nike shoes and Louis Vuitton bags in huge quantities. Those who had more delicate consciences would settle for near-counterfeits. There were shoes that looked like Nike but were called Nice, or shoes that had the Nike swoosh but with an extra prong. Counterfeit goods were rarely sold as the genuine article. Those who bought them were perfectly aware that they were buying fakes; the point was to make a fashion statement, rather than to mislead. Copyrighted items were treated in the same way. Today, Korea exports a large and increasing quantity of copyrighted materials (movies, TV soaps, popular songs), but at the time imported music (LP records) or films (videos) were so expensive that few people could afford the real thing.We grew up listening to pirate rock'n' roll records, which we called '*tempura* shop records', because their sound quality was so bad it sounded as if someone was deep-frying in the background. As for foreign books, they were still beyond the means of most students. Coming from a well-off family that was willing to invest in education, I did have some imported books. But most of my books in English were pirated. I could never have entered and survived Cambridge without those illegal books.

By the time I was finishing my graduate studies at Cambridge in the late 1980s, Korea had become a solid upper-middle-income country. The surest proof of this was that European countries stopped demanding that Koreans get an entry visa. Most of us by then had no reason to want to emigrate illegally anyway. In 1996, the country even joined the OECD (Organisation for Economic Co-operation and Development) – the club of the rich countries – and declared itself to have 'arrived', although that euphoria was badly deflated by the financial crisis that engulfed Korea in 1997. Since that financial crisis, the country has not been doing as well by its own high standards, mainly because it has over-enthusiastically embraced the 'free market rules' model. But that is a story for later.

Whatever its recent problems have been, Korea's economic growth and the resulting social transformation over the last four and a half decades have been truly spectacular. It has gone from being one of the poorest countries in the world to a country on a par with Portugal and Slovenia in terms of *per capita* income.[5] A country whose main exports included tungsten ore, fish and wigs made with human hair has become a high-tech powerhouse, exporting stylish mobile phones and flat-screen TVs coveted all over the world. Better nutrition and health care mean that a child born in Korea today can expect to live 24 years longer than someone born in the early 1960s (77 years instead of 53 years). Instead of 78 babies out of 1, 000, only five babies will die within a year of birth, breaking far fewer parents' hearts. In terms of these life-chance indicators, Korea's progress is as if Haiti had turned into Switzerland.[6] How has this 'miracle' been possible?

For most economists, the answer is a very simple one. Korea has succeeded because it has followed the dictates of the free market. It has embraced the

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principles of sound money (low inflation), small government, private enterprise, free trade and friendliness towards foreign investment. The view is known as neo-liberal economics.

Neo-liberal economics is an updated version of the liberal economics of the 18th-century economist Adam Smith and his followers. It first emerged in the 1960s and has been the dominant economic view since the 1980s. Liberal economists of the 18th and the 19th centuries believed that unlimited competition in the free market was the best way to organise an economy, because it forces everyone to perform with maximum efficiency. Government intervention was judged harmful because it reduces competitive pressure by restricting the entry of the potential competitors, whether through import controls or the creation of monopolies.Neo-liberal economists support certain things that the old liberals did not – most notably certain forms of monopoly (such as patents or the central bank's monopoly over the issue of bank notes) and political democracy. But in general they share the old liberals' enthusiasm for the free market.And despite a few 'tweaks' in the wake of a whole series of disappointing results of neo-liberal policies applied to developing nations during the past quarter of a century, the core neo-liberal agenda of deregulation, privatization and opening up of international trade and investment has remained the same since the 1980s.

In relation to the developing countries, the neo-liberal agenda has been pushed by an alliance of rich country governments led by the US and mediated by the 'Unholy Trinity' of international economic organizations that they largely control – the International Monetary Fund (IMF), the World Bank and the World Trade Organisation (WTO). The rich governments use their aid budgets and access to their

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home markets as carrots to induce the developing countries to adopt neo-liberal policies. This is sometimes to benefit specific firms that lobby, but usually to create an environment in the developing country concerned that is friendly to foreign goods and investment in general. The IMF and the World Bank play their part by attaching to their loans the condition that the recipient countries adopt neo-liberal policies. The WTO contributes by making trading rules that favour free trade in areas where the rich countries are stronger but not where they are weak (e.g., agriculture or textiles). These governments and international organizations are supported by an army of ideologues. Some of these people are highly trained academics who should know the limits of their free-market economics but tend to ignore them when it comes to giving policy advice (as happened especially when they advised the former communist economies in the 1990s). Together, these various bodies and individuals form a powerful propaganda machine, a financial-intellectual complex backed by money and power.

This neo-liberal establishment would have us believe that, during its miracle years between the 1960s and the 1980s, Korea pursued a neo-liberal economic development strategy.[7] The reality, however, was very different indeed. What Korea actually did during these decades was to nurture certain new industries, selected by the government in consultation with the private sector, through tariff protection, subsidies and other forms of government support (e.g., overseas marketing information services provided by the state export agency) until they 'grew up' enough to withstand international competition. The government owned all the banks, so it could direct the life blood of business – credit. Some big projects were undertaken directly by state-owned enterprises – the steel maker, POSCO,

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being the best example – although the country had a pragmatic, rather than ideological, attitude to the issue of state ownership. If private enterprises worked well, that was fine; if they did not invest in important areas, the government had no qualms about setting up state-owned enterprises (SOEs); and if some private enterprises were mismanaged, the government often took them over, restructured them, and usually (but not always) sold them off again.

The Korean government also had absolute control over scarce foreign exchange (violation of foreign exchange controls could be punished with the death penalty). When combined with a carefully designed list of priorities in the use of foreign exchange, it ensured that hard-earned foreign currencies were used for importing vital machinery and industrial inputs. The Korean government heavily controlled foreign investment as well, welcoming it with open arms in certain sectors while shutting it out completely in others, according to the evolving national development plan. It also had a lax attitude towards foreign patents, encouraging 'reverse engineering' and overlooking 'pirating' of patented products.

The popular impression of Korea as a free-trade economy was created by its export success. But export success does not require free trade, as Japan and China have also shown. Korean exports in the earlier period – things like simple garments and cheap electronics – were all means to earn the hard currencies needed to pay for the advanced technologies and expensive machines that were necessary for the new, more difficult industries, which were protected through tariffs and subsidies. At the same time, tariff protection and subsidies were not there to shield industries from international competition forever, but to give them the time to absorb new technologies and establish new organizational capabilities until they could compete in the world market.

The Korean economic miracle was the result of a clever and pragmatic mixture of market incentives and state direction. The Korean government did not vanquish the market as the communist states did. However, it did not have blind faith in the free market either. While it took markets seriously, the Korean strategy recognized that they often need to be corrected through policy intervention.

Now, if it was only Korea that became rich through such 'heretical' policies, the free-market gurus might be able to dismiss it as merely the exception that proves the rule. However, Korea is no exception. As I shall show later, practically *all* of today's developed countries, including Britain and the US, the supposed homes of the free market and free trade, have become rich on the basis of policy recipes that go against the orthodoxy of neo-liberal economics.

Today's rich countries used protection and subsidies, while discriminating against foreign investors – all anathema to today's economic orthodoxy and now severely restricted by multilateral treaties, like the WTO Agreements, and proscribed by aid donors and international financial organizations (notably the IMF and the World Bank). There are a few countries that did not use much protection, such as the Netherlands and (until the First World War) Switzerland. But they deviated from the orthodoxy in other ways, such as their refusal to protect patents. The records of today's rich countries on policies regarding foreign investment, state-owned enterprises, macroeconomic management and political institutions also show significant deviations from today's orthodoxy regarding these matters.

Why then don't the rich countries recommend to

today's developing countries the strategies that served them so well? Why do they instead hand out a fiction about the history of capitalism, and a bad one at that?

In 1841, a German economist, Friedrich List, criticized Britain for preaching free trade to other countries, while having achieved its economic supremacy through high tariffs and extensive subsidies. He accused the British of 'kicking away the ladder' that they had climbed to reach the world's top economic position: '[i]t is a very common clever device that when anyone has attained the summit of greatness, he *kicks away the ladder* by which he has climbed up, in order to deprive others of the means of climbing up after him [italics added]'.[8]

Today, there are certainly some people in the rich countries who preach free market and free trade to the poor countries in order to capture larger shares of the latter's markets and to pre-empt the emergence of possible competitors. They are saying 'do as we say, not as we did' and act as 'Bad Samaritans', taking advantage of others who are in trouble.[*] But what is more worrying is that many of today's Bad Samaritans do not even realize that they are hurting the developing countries with their policies. The history of capitalism has been so totally re-written that many people in the rich world do not perceive the historical double standards involved in recommending free trade and free market to developing countries.

I am not suggesting that there is a sinister secret committee somewhere that systematically air-brushes undesirable people out of photographs and re-writes historical accounts. However, history is written by the victors and it is human nature to re-interpret the past from the point of view of the present. As a result, the rich countries have, over time, gradually, if often sub-consciously, re-written their own histories to make them more consistent with how they see themselves today, rather than as they really were – in much the same way that today people write about Renaissance 'Italy' (a country that did not exist until 1871) or include the French-speaking Scandinavians (Norman conqueror kings) in the list of 'English' kings and queens.

The result is that many Bad Samaritans are recommending free-trade, free-market policies to the poor countries in the honest but mistaken belief that those are the routes their own countries took in the past to become rich. But they are in fact making the lives of those whom they are trying to help more difficult. Sometimes these Bad Samaritans may be more of a problem than those knowingly engaged in 'kicking away the ladder', because self-righteousness is often more stubborn than self-interest.

So how do we dissuade the Bad Samaritans from hurting the poor countries, whatever their intentions are? What else should they do instead? This book offers some answers through a mix of history, analysis of the world today, some future predictions and suggestions for change.

The place to start is with a true history of capitalism and globalization, which I examine in the next two chapters (chapters 1 and 2). In these chapters, I will show how many things that the reader may have accepted as 'historical facts' are either wrong or partial truths. Britain and the US are *not* the homes of free trade; in fact, for a long time they were the most protectionist countries in the world. Not all countries have succeeded through protection and subsidies, but few have done so without them. For developing countries, free trade has rarely been a matter of choice; it was often an imposition from outside, sometimes even through military power. Most of them did very

poorly under free trade; they did much better when they used protection and subsidies. The best-performing economies have been those that opened up their economies selectively and gradually. Neo-liberal free-trade free-market policy claims to sacrifice equity for growth, but in fact it achieves neither; growth has slowed down in the past two and a half decades when markets were freed and borders opened.

In the main chapters of the book that follow the historical chapters (chapters 3 to 9), I deploy a mixture of economic theory, history and contemporary evidence to turn much of the conventional wisdom about development on its head.

- Free trade reduces freedom of choice for poor countries.
- Keeping foreign companies out may be good for them in the long run.
- Investing in a company that is going to make a loss for 17 years may be an excellent proposition.
- Some of the world's best firms are owned and run by the state.
- 'Borrowing' ideas from more productive foreigners is essential for economic development.
- Low inflation and government prudence may be harmful for economic development.
- Corruption exists because there is too much, not too little, market.
- Free market and democracy are not natural partners.
- Countries are poor not because their people are lazy; their people are 'lazy' because they are poor.

Like this opening chapter, the closing chapter of the book opens with an alternative 'future history' – but this time a very bleak one. The scenario is deliberately pessimistic, but it is firmly rooted in reality, showing how close we are to such a future, should we continue with the neo-liberal policies propagated by the Bad Samaritans. In the rest of the chapter, I present some key principles, distilled from the detailed policy alternatives that I discuss throughout the book, which should guide our action if we are to enable developing countries to advance their economies. Despite its bleak scenario, the chapter – and therefore the book – closes with a note of optimism, explaining why I believe most Bad Samaritans can be changed and really made to help developing countries improve their economic situations.

* Samsung in Korean means Three Stars, as does my fictitious Mozambican firm, Tres Estrelas. The last sentence in my imaginary 2061 *Economist* piece is based on a real *Economist* article about Samsung, 'As good as it gets?' (January 13 2005), whose final sentence reads: 'Might a relatively unknown electronics manufacturer somewhere in China decide that, if Samsung was able to move from the darkest shadows to the top of the tree, then perhaps it could too?' The 17 years during which the fuel cell division of my fictitious Mozambican firm lost money is the same investment period during which the electronics division of Nokia, founded in 1960, lost money.

* The original story is that of the 'Good Samaritan' from the Bible. In that parable, a man who was robbed by highwaymen was helped by a 'Good Samaritan', despite the fact that the Samaritans were stereotyped as being callous and not above taking advantage of the others in trouble.

CHAPTER 1

The Lexus and the olive tree revisited

Myths and facts about globalization

Once upon a time, the leading car maker of a developing country exported its first passenger cars to the US. Up to that day, the little company had only made shoddy products – poor copies of quality items made by richer countries. The car was nothing too sophisticated – just a cheap subcompact (one could have called it 'four wheels and an ashtray'). But it was a big moment for the country and its exporters felt proud.

Unfortunately, the product failed.Most thought the little car looked lousy and savvy buyers were reluctant to spend serious money on a family car that came from a place where only second-rate products were made. The car had to be withdrawn from the US market. This disaster led to a major debate among the country's citizens.

Many argued that the company should have stuck to its original business of making simple textile machinery. After all, the country's biggest export item was silk. If the company could not make good cars after 25 years of trying, there was no future for it. The government had given the car maker every opportunity to succeed. It had ensured high profits for it at home through high tariffs and draconian controls on foreign investment in the car industry. Fewer than ten years ago, it even gave public money to save the company from imminent bankruptcy. So, the critics argued, foreign cars should now be let in freely and foreign car makers, who had been kicked out 20 years before, allowed to set up shop again.

Others disagreed. They argued that no country had got anywhere without developing 'serious' industries like automobile production. They just needed more time to make cars that appealed to everyone.

The year was 1958 and the country was, in fact, Japan. The company was Toyota, and the car was called the Toyopet. Toyota started out as a manufacturer of textile machinery (Toyoda Automatic Loom) and moved into car production in 1933. The Japanese government kicked out General Motors and Ford in 1939 and bailed out Toyota with money from the central bank (Bank of Japan) in 1949. Today, Japanese cars are considered as 'natural' as Scottish salmon or French wine, but fewer than 50 years ago, most people, including many Japanese, thought the Japanese car industry simply should not exist.

Half a century after the Toyopet debacle, Toyota's luxury brand Lexus has become something of an icon for globalization, thanks to the American journalist Thomas Friedman's book, *The Lexus and the Olive Tree*. The book owes its title to an epiphany that Friedman had on the Shinkansen bullet train during his trip to Japan in 1992. He had paid a visit to a Lexus factory, which mightily impressed him. On his train back from the car factory in Toyota City to Tokyo, he came across yet another newspaper article about the troubles in the Middle East where he had been a long-time correspondent. Then it hit him. He realized that that 'half the world seemed to be . . . intent on building a better Lexus, dedicated to modernizing, streamlining, and privatizing their economies in order to thrive in the system of globalization.And half of the world – sometimes half the same country, sometimes half the

same person – was still caught up in the fight over who owns which olive tree'.[1]

According to Friedman, unless they fit themselves into a particular set of economic policies that he calls the Golden Straitjacket, countries in the olive-tree world will not be able to join the Lexus world. In describing the Golden Straitjacket, he pretty much sums up today's neo-liberal economic orthodoxy: in order to fit into it, a country needs to privatize state-owned enterprises, maintain low inflation, reduce the size of government bureaucracy, balance the budget (if not running a surplus), liberalize trade, deregulate foreign investment, deregulate capital markets, make the currency convertible, reduce corruption and privatize pensions.[2] According to him, this is the only path to success in the new global economy. His Straitjacket is the only gear suitable for the harsh but exhilarating game of globalization. Friedman is categorical: 'Unfortunately, this Golden Straitjacket is pretty much "one-size fits all" . . . It is not always pretty or gentle or comfortable. But it's here and it's the only model on the rack this historical season.'[3]

However, the fact is that, had the Japanese government followed the free-trade economists back in the early 1960s, there would have been no Lexus. Toyota today would, at best, be a junior partner to some western car manufacturer, or worse, have been wiped out. The same would have been true for the entire Japanese economy. Had the country donned Friedman's Golden Straitjacket early on, Japan would have remained the third-rate industrial power that it was in the 1960s, with its income level on a par with Chile, Argentina and South Africa[4] – it was then a country whose prime minister was insultingly dismissed as 'a transistor-radio salesman' by the French president, Charles De Gaulle.[5] In other words, had they followed Friedman's advice, the Japanese would now not be exporting the Lexus but still be fighting over who owns which mulberry tree.

The official history of globalization

Our Toyota story suggests that there is something spectacularly jarring in the fable of globalization promoted by Thomas Friedman and his colleagues. In order to tell you what it is exactly, I need to tell you what I call the 'official history of globalization' and discuss its limitations.

According to this history, globalization has progressed over the last three centuries in the following way:[6] Britain adopted free-market and free-trade policies in the 18th century, well ahead of other countries. By the middle of the 19th century, the superiority of these policies became so obvious, thanks to Britain's spectacular economic success, that other countries started liberalizing their trade and deregulating their domestic economies. This liberal world order, perfected around 1870 under British hegemony, was based on: *laissez-faire* industrial policies at home; low barriers to the international flows of goods, capital and labour; and macroeconomic stability, both nationally and internationally, guaranteed by the principles of sound money (low inflation) and balanced budgets. A period of unprecedented prosperity followed.

Unfortunately, things started to go wrong after the First World War. In response to the ensuing instability of the world economy, countries unwisely began to erect trade barriers again. In 1930, the US abandoned free trade and enacted the infamous Smoot-Hawley tariff. Countries like Germany and Japan abandoned liberal policies and erected high trade barriers and

created cartels, which were intimately associated with their fascism and external aggression. The world free trade system finally ended in 1932, when Britain, hitherto the champion of free trade, succumbed to temptation and itself re-introduced tariffs. The resulting contraction and instability in the world economy, and then, finally, the Second World War, destroyed the last remnants of the first liberal world order.

After the Second World War, the world economy was re-organized on a more liberal line, this time under American hegemony. In particular, some significant progress was made in trade liberalization among the rich countries through the early GATT (General Agreement on Trade and Tariffs) talks. But protectionism and state intervention still persisted in most developing countries and, needless to say, in the communist countries.

Fortunately, illiberal policies have been largely abandoned across the world since the 1980s following the rise of neo-liberalism. By the late 1970s, the failures of so-called import substitution industrialization (ISI) in developing countries – based on protection, subsidies and regulation – had become too obvious to ignore.[*] The economic 'miracle' in East Asia, which was already practising free trade and welcoming foreign investment, was a wake-up call for the other developing countries.After the 1982 Third World debt crisis, many developing countries abandoned interventionism and protectionism, and embraced neo-liberalism. The crowning glory of this trend towards global integration was the fall of communism in 1989.

These national policy changes were made all the more necessary by the unprecedented acceleration in the development of transport and communications technologies. With these developments, the possibilities of entering mutually beneficial economic arrangements with partners in faraway countries – through international trade and investment – increased dramatically. This has made openness an even more crucial determinant of a country's prosperity than before.

Reflecting the deepening global economic integration, the global governance system has recently been strengthened.Most importantly, in 1995 the GATT was upgraded to the WTO (World Trade Organisation), a powerful agency pushing for liberalization not just in trade but also in other areas, like foreign investment regulation and intellectual property rights. The WTO now forms the core of the global economic governance system, together with the IMF (International Monetary Fund) – in charge of access to short-term finance – and the World Bank – in charge of longer-term investments.

The result of all these developments, according to the official history, is a globalized world economy comparable in its liberality and potential for prosperity only to the earlier 'golden age' of liberalism (1870–1913). Renato Ruggiero, the first director-general of the WTO, solemnly declared that, as a consequence of this new world order, we now have 'the potential for eradicating global poverty in the early part of the next [21st] century – a Utopian notion even a few decades ago, but a real possibility today.'[7]

This version of the history of globalization is widely accepted. It is supposed to be the route map for policy makers in steering their countries towards prosperity. Unfortunately, it paints a fundamentally misleading picture, distorting our understanding of where we have come from, where we are now and where we may be heading for. Let's see how.

The real history of globalization

On 30 June 1997, Hong Kong was officially handed back to China by its last British governor, Christopher Patten. Many British commentators fretted about the fate of Hong Kong's democracy under the Chinese Communist Party, although democratic elections in Hong Kong had only been permitted as late as 1994, 152 years after the start of British rule and only three years before the planned hand-over. But no one seems to remember how Hong Kong came to be a British possession in the first place.

Hong Kong became a British colony after the Treaty of Nanking in 1842, the result of the Opium War. This was a particularly shameful episode, even by the standards of 19th-century imperialism. The growing British taste for tea had created a huge trade deficit with China. In a desperate attempt to plug the gap, Britain started exporting opium produced in India to China. The mere detail that selling opium was illegal in China could not possibly be allowed to obstruct the noble cause of balancing the books. When a Chinese official seized an illicit cargo of opium in 1841, the British government used it as an excuse to fix the problem once and for all by declaring war. China was heavily defeated in the war and forced to sign the Treaty of Nanking, which made China 'lease' Hong Kong to Britain and give up its right to set its own tariffs.

So there it was – the self-proclaimed leader of the 'liberal' world declaring war on another country because the latter was getting in the way of its illegal trade in narcotics. The truth is that the free movement of goods, people, and money that developed under British hegemony between 1870 and 1913 – the first episode of globalization – was made possible, in large part, by military might, rather than market forces. Apart from Britain itself, the practitioners of free trade during this period were mostly weaker countries that had been forced into, rather than had voluntarily adopted, it as a result of colonial rule or 'unequal treaties' (like the Nanking Treaty), which, among other things, deprived them of the right to set tariffs and imposed externally determined low, flat-rate tariffs (3–5%) on them.[8]

Despite their key role in promoting 'free' trade in the late 19th and early 20th centuries, colonialism and unequal treaties hardly get any mention in the hordes of pro-globalisation books.[9] Even when they are explicitly discussed, their role is seen as positive on the whole. For example, in his acclaimed book, *Empire*, the British historian Niall Ferguson honestly notes many of the misdeeds of the British empire, including the Opium War, but contends that the British empire was a good thing overall – it was arguably the cheapest way to guarantee free trade, which benefits everyone.[10] However, the countries under colonial rule and unequal treaties did very poorly. Between 1870 and 1913, *per capita* income in Asia (excluding Japan) grew at 0.4% per year, while that in Africa grew at 0.6% per year.[11] The corresponding figures were 1.3% for Western Europe and 1.8% per year for the USA.[12] It is particularly interesting to note that the Latin American countries, which by that time had regained tariff autonomy and were boasting some of the highest tariffs in the world, grew as fast as the US did during this period.[13]

While they were imposing free trade on weaker nations through colonialism and unequal treaties, rich countries maintained rather high tariffs, especially industrial tariffs, for themselves, as we will see in greater detail in the next chapter.To begin with, Britain,

the supposed home of free trade, was one of the most protectionist countries until it converted to free trade in the mid-19th century. There was a brief period during the 1860s and the 1870s when something approaching free trade did exist in Europe, especially with zero tariffs in Britain. However, this proved short-lived. From the 1880s, most European countries raised protective barriers again, partly to protect their farmers from cheap food imported from the New World and partly to promote their newly emerging heavy industries, such as steel, chemicals and machinery.[14] Finally, even Britain, as I have noted, the chief architect of the first wave of globalization, abandoned free trade and re-introduced tariffs in 1932. The official history describes this event as Britain 'succumbing to the temptation' of protectionism. But it typically fails to mention that this was due to the decline in British economic supremacy, which in turn was the result of the success of protectionism on the part of competitor countries, especially the USA, in developing their own new industries.

Thus, the history of the first globalization in the late 19th and early 20th centuries has been rewritten today in order to fit the current neo-liberal orthodoxy. The history of protectionism in today's rich countries is vastly underplayed, while the imperialist origin of the high degree of global integration on the part of today's developing countries is hardly ever mentioned. The final curtain coming down on the episode – that is, Britain's abandonment of free trade – is also presented in a biased way. It is rarely mentioned that what really made Britain abandon free trade was precisely the successful use of protectionism by its competitors.

Neo-liberals vs neo-idiotics?

In the official history of globalization, the early post-Second-World-War period is portrayed as a period of incomplete globalization.While there was a significant increase in integration among the rich countries, accelerating their growth, it is said, most developing countries refused to fully participate in the global economy until the 1980s, thus holding themselves back from economic progress.

This story misrepresents the process of globalization among the rich countries during this period. These countries did significantly lower their tariff barriers between the 1950s and the 1970s. But during this period, they also used many other nationalistic policies to promote their own economic development – subsidies (especially for research and development, or R&D), state-owned enterprises, government direction of banking credits, capital controls and so on. When they started implementing neo-liberal programmes, their growth decelerated. In the 1960s and the 1970s, *per capita* income in the rich countries grew by 3.2% a year, but its growth rate fell substantially to 2.1% in the next two decades.[15]

But more misleading is the portrayal of the experiences of developing countries. The postwar period is described by the official historians of globalization as an era of economic disasters in these countries. This was because, they argue, these countries believed in 'wrong' economic theories that made them think they could defy market logic. As a result, they suppressed activities which they were good at (agriculture, mineral extraction and labour-intensive manufacturing) and promoted 'white elephant' projects that made them feel proud but were economic nonsense – the most notorious example of this is Indonesia producing heavily subsidized jet aeroplanes.

The right to 'asymmetric protection' that the

developing countries secured in 1964 at the GATT is portrayed as 'the proverbial rope on which to hang one's own economy!', in a well-known article by Jeffrey Sachs and Andrew Warner.[16] Gustavo Franco, a former president of the Brazilian central bank (1997–99), made the same point more succinctly, if more crudely, when he said his policy objective was 'to undo forty years of stupidity' and that the only choice was 'to be neo-liberal or neo-idiotic'.[17]

The problem with this interpretation is that the 'bad old days' in the developing countries weren't so bad at all. During the 1960s and the 1970s, when they were pursuing the 'wrong' policies of protectionism and state intervention, *per capita* income in the developing countries grew by 3.0% annually.[18] As my esteemed colleague Professor Ajit Singh once pointed out, this was the period of 'Industrial Revolution in the Third World'.[19] This growth rate is a huge improvement over what they achieved under free trade during the 'age of imperialism' (see above) and compares favourably with the 1–1. 5% achieved by the rich countries during the Industrial Revolution in the 19th century. It also remains the best that they have ever recorded. Since the 1980s, after they implemented neo-liberal policies, they grew at only about half the speed seen in the 1960s and the 1970s (1.7%). Growth slowed down in the rich countries too, but the slowdown was less marked (from 3.2% to 2.1%), not least because they did not introduce neo-liberal policies to the same extent as the developing countries did. The average growth rate of developing countries in this period would be even lower if we exclude China and India. These two countries, which accounted for 12% of total developing country income in 1980 and 30% in 2000, have so far refused to put on Thomas Friedman's Golden Straitjacket.[20]

Growth failure has been particularly noticeable in

Latin America and Africa, where neo-liberal programmes were implemented more thoroughly than in Asia. In the 1960s and the 1970s, *per capita* income in Latin America was growing at 3.1% per year, slightly faster than the developing country average. Brazil, especially, was growing almost as fast as the East Asian 'miracle' economies. Since the 1980s, however, when the continent embraced neo-liberalism, Latin America has been growing at less than one-third of the rate of the 'bad old days'. Even if we discount the 1980s as a decade of adjustment and take it out of the equation, *per capita* income in the region during the 1990s grew at basically half the rate of the 'bad old days' (3.1% vs 1.7%). Between 2000 and 2005, the region has done even worse; it virtually stood still, with *per capita* income growing at only 0.6% per year.[21] As for Africa, its *per capita* income grew relatively slowly even in the 1960s and the 1970s (1–2% a year). But since the 1980s, the region has seen a *fall* in living standards. This record is a damning indictment of the neo-liberal orthodoxy, because most of the African economies have been practically run by the IMF and the World Bank over the past quarter of a century.

The poor *growth* record of neo-liberal globalization since the 1980s is particularly embarrassing. Accelerating growth – if necessary at the cost of increasing inequality and possibly some increase in poverty – was the proclaimed goal of neo-liberal reform. We have been repeatedly told that we first have to 'create more wealth' before we can distribute it more widely and that neo-liberalism was the way to do that. As a result of neo-liberal policies, income inequality has increased in most countries as predicted, but growth has actually slowed down significantly.[22]

Moreover, economic instability has markedly increased during the period of neo-liberal dominance.

The world, especially the developing world, has seen more frequent and larger-scale financial crises since the 1980s. In other words, neo-liberal globalization has failed to deliver on all fronts of economic life – growth, equality and stability. Despite this, we are constantly told how neo-liberal globalization has brought unprecedented benefits.

The distortion of facts in the official history of globalization is also evident at country level. Contrary to what the orthodoxy would have us believe, virtually all the successful developing countries since the Second World War initially succeeded through nationalistic policies, using protection, subsidies and other forms of government intervention.

I have already discussed the case of my native Korea in some detail in the Prologue, but other 'miracle' economies of East Asia have also succeeded through a strategic approach to integration with the global economy. Taiwan used a strategy that is very similar to that of Korea, although it used state-owned enterprises more extensively while being somewhat friendlier to foreign investors than Korea was. Singapore has had free trade and relied heavily on foreign investment, but, even so, it does not conform in other respects to the neo-liberal ideal. Though it welcomed foreign investors, it used considerable subsidies in order to attract transnational corporations in industries it considered strategic, especially in the form of government investment in infrastructure and education targeted at particular industries. Moreover, it has one of the largest state-owned enterprise sectors in the world, including the Housing Development Board, which supplies 85% of all housing (almost all land is owned by the government).

Hong Kong is the exception that proves the rule. It became rich despite having free trade and a *laissez-*

faire industrial policy. But it never was an independent state (not even a city state like Singapore) but a city within a bigger entity. Until 1997, it was a British colony used as a platform for Britain's trading and financial interests in Asia. Today, it is the financial centre of the Chinese economy. These facts made it less necessary for Hong Kong to have an independent industrial base, although, even so, it was producing twice as much manufacturing output *per capita* as that of Korea until the mid-1980s, when it started its full absorption into China. But even Hong Kong was not a total free market economy. Most importantly, all land was owned by the government in order to control the housing situation.

The more recent economic success stories of China, and increasingly India, are also examples that show the importance of strategic, rather than unconditional, integration with the global economy based on a nationalistic vision. Like the US in the mid-19th century, or Japan and Korea in the mid-20th century, China used high tariffs to build up its industrial base. Right up to the 1990s, China's average tariff was over 30%. Admittedly, it has been more welcoming to foreign investment than Japan or Korea were. But it still imposed foreign ownership ceilings and local contents requirements (the requirements that the foreign firms buy at least a certain proportion of their inputs from local suppliers).

India's recent economic success is often attributed by the pro-globalizers to its trade and financial liberalization in the early 1990s. As some recent research reveals, however, India's growth acceleration really began in the 1980s, discrediting the simple 'greater openness accelerates growth' story.[23] Moreover, even after the early 1990s trade liberalization, India's average manufacturing tariffs

remained at above 30% (it is still 25% today). India's protectionism before the 1990s was certainly over-done in some sectors. But this is not to say that India would have been even more successful had it adopted free trade at independence in 1947. India has also imposed severe restrictions on foreign direct investment – entry restrictions, ownership restrictions and various performance requirements (e.g., local contents requirements).

The one country that seems to have succeeded in the postwar globalization period by using the neo-liberal strategy is Chile. Indeed, Chile adopted the strategy before anyone else, including the US and Britain, following the *coup d'état* by General Augusto Pinochet back in 1973. Since then, Chile has grown quite well – although nowhere nearly as fast as the East Asian 'miracle' economies.[24] And the country has been constantly cited as a neo-liberal success story. Its good growth performance is undeniable. But even Chile's story is more complex than the orthodoxy suggests.

Chile's early experiment with neo-liberalism, led by the so-called Chicago Boys (a group of Chilean economists trained at the University of Chicago, one of the centres of neo-liberal economics), was a disaster. It ended in a terrible financial crash in 1982, which had to be resolved by the nationalization of the whole banking sector. Thanks to this crash, the country recovered the pre-Pinochet level of income only in the late 1980s.[25] It was only when Chile's neo-liberalism got more pragmatic after the crash that the country started doing well. For example, the government provided exporters with a lot of help in overseas marketing and R&D.[26] It also used capital controls in the 1990s to successfully reduce the inflow of short-term speculative funds, although its recent free trade agreement with the US has forced it to promise never to use them again.More importantly, there is a lot of doubt about the sustainability of Chile's development. Over the past three decades, the country has lost a lot of manufacturing industries and become excessively dependent on natural-resources-based exports. Not having the technological capabilities to move into higher-productivity activities, Chile faces a clear limit to the level of prosperity it can attain in the long run.

To sum up, the truth of post-1945 globalization is almost the polar opposite of the official history. During the period of controlled globalization underpinned by nationalistic policies between the 1950s and the 1970s, the world economy, especially in the developing world, was growing faster, was more stable and had more equitable income distribution than in the past two and a half decades of rapid and uncontrolled neo-liberal globalization. Nevertheless, this period is portrayed in the official history as a one of unmitigated disaster of nationalistic policies, especially in developing countries. This distortion of the historical record is peddled in order to mask the failure of neo-liberal policies.

Who's running the world economy?

Much of what happens in the global economy is determined by the rich countries, without even trying. They account for 80% of world output, conduct 70% of international trade and make 70–90% (depending on the year) of all foreign direct investments.[27] This means that their national policies can strongly influence the world economy.

But more important than their sheer weight is the rich countries' willingness to throw that very weight about in shaping the rules of the global economy. For example, developed countries induce poorer countries

to adopt particular policies by making them a condition for their foreign aid or by offering them preferential trade agreements in return for 'good behaviour' (adoption of neo-liberal policies). Even more important in shaping options for developing countries, however, are the actions ofmultilateral organizations such as the 'Unholy Trinity' – namely the IMF, the World Bank and the WTO (World Trade Organisation). Though they are not merely puppets of the rich countries, the Unholy Trinity are largely controlled by the rich countries, so they devise and implement Bad Samaritan policies that those countries want.

The IMF and the World Bank were originally set up in 1944 at a conference between the Allied forces (essentially the US and Britain), which worked out the shape of postwar international economic governance. This conference was held in the New Hampshire resort of Bretton Woods, so these agencies are sometimes collectively called the Bretton Woods Institutions (BWIs). The IMF was set up to lend money to countries in balance of payments crises so that they can reduce their balance of payments deficits without having to resort to deflation. The World Bank was set up to help the reconstruction of war-torn countries in Europe and the economic development of the post-colonial societies that were about to emerge – which is why it is officially called the International Bank for Reconstruction and Development. This was supposed to be done by financing projects in infrastructure development (e.g., roads, bridges, dams).

Following the Third World debt crisis of 1982, the roles of both the IMF and the World Bank changed dramatically. They started to exert a much stronger policy influence on developing countries through their joint operation of so-called structural adjustment programmes (SAPs). These programmes covered a much wider range of policies than what the Bretton Woods Institutions had originally been mandated to do. The BWIs now got deeply involved in virtually all areas of economic policy in the developing world. They branched out into areas like government budgets, industrial regulation, agricultural pricing, labour market regulation, privatization and so on. In the 1990s, there was a further advance in this 'mission creep' as they started attaching so-called governance conditionalities to their loans. These involved intervention in hitherto unthinkable areas, like democracy, government decentralization, central bank independence and corporate governance.

This mission creep raises a serious issue. The World Bank and the IMF initially started with rather limited mandates. Subsequently, they argued that they have to intervene in new areas outside their original mandates, as they, too, affect economic performance, a failure in which has driven countries to borrow money from them. However, on this reasoning, there is no area of our life in which the BWIs cannot intervene. Everything that goes on in a country has implications for its economic performance. By this logic, the IMF and the World Bank should be able to impose conditionalities on everything from fertility decisions, ethnic integration and gender equality, to cultural values.

Don't get me wrong. I am not one of those people who are against loan conditionalities on principle. It is reasonable for the lender to attach conditions. But conditions should be confined to only those aspects that are most relevant to the repayment of the loan. Otherwise, the lender may intrude in all aspects of the borrower's life.

Suppose I am a small businessman trying to borrow money from my bank in order to expand my factory. It would be natural for my bank manager to impose a

unilateral condition on how I am going to repay. It might even be reasonable for him to impose conditions on what kind of construction materials I can use and what kind of machinery I can buy in expanding my factory. But, if he attaches the condition that I cut down on my fat intake on the (not totally irrelevant) grounds that a fatty diet reduces my ability to repay the loan by making me unhealthy, I would find this unreasonably intrusive. Of course, if I am really desperate, I may swallow my pride and agree even to this unreasonable condition. But when he makes it a further condition that I spend less than an hour a day at home (on the grounds that spending less time with the family will increase my time available for business and therefore reduce the chance of loan default), I would probably punch him in the face and storm out of the bank. It is not that my diet and family life have no bearings whatsoever on my ability to manage my business. As my bank manager reasons, they *are* relevant. But the point is that their relevance is indirect and marginal.

In the beginning, the IMF only imposed conditions closely related to the borrower country's management of its balance of payments, such as currency devaluation. But then it started putting conditions on government budgets on the grounds that budget deficits are a key cause of balance of payments problems. This led to the imposition of conditions like the privatization of state-owned enterprises, because it was argued that the losses made by those enterprises were an important source of budget deficits in many developing countries. Once such an extension of logic began, there was no stopping. Since everything is related to everything else, anything could be a condition. In 1997, in Korea, for example, the IMF laid down conditions on the amount of debt that *private sector* companies could have, on the grounds that over-borrowing by these companies was the main reason for Korea's financial crisis.

To add insult to injury, the Bad Samaritan rich nations often demand, as a condition for their financial contribution to IMF packages, that the borrowing country be made to adopt policies that have little to do with fixing its economy but that serve the interests of the rich countries lending the money. For example, on seeing Korea's 1997 agreement with the IMF, one outraged observer commented: 'Several features of the IMF plan are replays of the policies that Japan and the United States have long been trying to get Korea to adopt. These included accelerating the . . . reductions of trade barriers to specific Japanese products and opening capital markets so that foreign investors can have majority ownership of Korean firms, engage in hostile takeovers . . . , and expand direct participation in banking and other financial services. Although greater competition from manufactured imports and more foreign ownership could . . . help the Korean economy, Koreans and others saw this . . . as an abuse of IMF power to force Korea at a time of weakness to accept trade and investment policies it had previously rejected'.[28] This was said not by some anti-capitalist anarchist but by Martin Feldstein, the conservative Harvard economist who was the key economic advisor to Ronald Reagan in the 1980s.

The IMF-World Bank mission creep, combined with the abuse of conditionalities by the Bad Samaritan nations, is particularly unacceptable when the policies of the Bretton Woods Institutions have produced slower growth, more unequal income distribution and greater economic instability in most developing countries, as I pointed out earlier in this chapter.

How on earth can the IMF and the World Bank persist for so long in pursuing the wrong policies that

produce such poor outcomes? This is because their governance structure severely biases them towards the interests of the rich countries. Their decisions are made basically according to the share capital that a country has (in other words, they have a one-dollar-one-vote system). This means that the rich countries, which collectively control 60% of the voting shares, have an absolute control over their policies, while the US has a *de facto* veto in relation to decisions in the 18 most important areas.[29]

One result of this governance structure is that the World Bank and the IMF have imposed on developing countries standard policy packages that are considered to be universally valid by the rich countries, rather than policies that are carefully designed for each particular developing country – predictably producing poor results as a consequence. Another result is that, even when their policies may be appropriate, they have often failed because they are resisted by the locals as impositions from outside.

In response to mounting criticisms, the World Bank and the IMF have recently reacted in a number of ways. On the one hand, there have been some window-dressing moves. Thus the IMF now calls the Structural Adjustment Programme the Poverty Reduction and Growth Facility Programme, in order to show that it cares about poverty issues, though the contents of the programme have hardly changed from before. On the other hand, there have been some genuine efforts to open dialogues with a wider constituency, especially the World Bank's engagement with NGOs (non-governmental organizations). But the impacts of such consultation are at best marginal. Moreover, when increasing numbers of NGOs in developing countries are indirectly funded by the World Bank, the value of such an exercise is becoming more doubtful.

The IMF and the World Bank have also tried to increase the 'local ownership'of their programmes by involving local people in their design. However, this has borne few fruits. Many developing countries lack the intellectual resources to argue against powerful international organizations with an army of highly trained economists and a lot of financial clout behind them. Moreover, the World Bank and the IMF have taken what I call the 'Henry Ford approach to diversity' (he once said that a customer could have a car painted 'any colour . . . so long as it's black'). The range of local variation in policies that they find acceptable is very narrow. Also, with the increasing tendency for developing countries to elect or appoint ex-World Bank or ex-IMF officials to key economic posts, 'local' solutions are increasingly resembling the solutions provided by the Bretton Woods Institutions.

Completing the Unholy Trinity, the World Trade Organisation was launched in 1995, following the conclusion of the so-called Uruguay Round of the GATT talks. I will discuss the substance of what the WTO does in greater detail in later chapters, so here let me focus just on its governance structure.

The World Trade Organisation has been criticized on a number of grounds. Many believe that it is little more than a tool with which the developed countries pry open developing markets. Others argue that it has become a vehicle for furthering the interests of transnational corporations. There are elements of truth in both of these criticisms, as I will show in later chapters.

But, despite these criticisms, the World Trade Organisation is an international organization in whose running the developing countries have the greatest say. Unlike the IMF or the World Bank, it is 'democratic' – in the sense of allowing one country one vote (of course,

we can debate whether giving China, with 1.3 billion people, and Luxembourg, with fewer than half a million people, one vote each is really 'democratic'). And, unlike in the UN, where the five permanent members of the Security Council have veto power, no country has a veto in the WTO. Since they have the numerical advantage, the developing countries count far more in the WTO than they do in the IMF or the World Bank.

Unfortunately, in practice, votes are never taken, and the organization is essentially run by an oligarchy comprising a small number of rich countries. It is reported that, in various ministerial meetings (Geneva 1998, Seattle 1999, Doha 2001, Cancun 2003), all the important negotiations were held in the so-called Green Rooms on a 'by-invitation-only' basis. Only the rich countries and some large developing countries that they cannot ignore (e.g., India and Brazil) were invited. Especially during the 1999 Seattle meeting, it was reported that some developing country delegates who tried to get into Green Rooms without invitations were physically thrown out.

But even without such extreme measures, the decisions are likely to be biased towards the rich countries. They can threaten and bribe developing countries by means of their foreign aid budgets or using their influence on the loan decisions by the IMF, the World Bank and 'regional' multilateral financial institutions.*

Moreover, there exists a vast gap in intellectual and negotiation resources between the two groups of countries. A former student of mine, who has just left the diplomatic service of his native country in Africa, once told me that his country had only three people, including himself, to attend all the meetings at the WTO in Geneva. The meetings often numbered more than a dozen a day, so he and his colleagues dropped a few meetings altogether and divided up the rest between the three of them. This meant that they could allocate only two to three hours to each meeting. Sometimes they went in at the right moment and made some useful contributions. Some other times, they were not so lucky and got completely lost. In contrast, the US – to take the example at the other extreme – had dozens of people working on intellectual property rights alone. But my former student said, his country was lucky – more than 20 developing countries do not have a single person based in Geneva, and many have to get by with only one or two people. Many more stories like this could be told, but they all suggest that international trade negotiations are a highly lopsided affair; it is like a war where some people fight with pistols while the others engage in aerial bombardment.

Are the Bad Samaritans winning?

Margaret Thatcher, the British prime minister who spearheaded the neo-liberal counter-revolution, once famously dismissed her critics saying that 'There is no alternative'. The spirit of this argument – known as TINA (There Is No Alternative) – permeates the way globalization is portrayed by the Bad Samaritans.

The Bad Samaritans like to present globalization as an inevitable result of relentless developments in the technologies of communication and transportation. They like to portray their critics as backward-looking 'modern-day Luddites'[30] who 'fight over who owns which olive tree'. Going against this historical tide only produces disasters, it is argued, as evidenced by the collapse of the world economy during the inter-war period and by the failures of state-led industrialization in the developing countries in the 1960s and the 1970s. It is argued that there is only one way to survive the historic tidal force that is globalization, and that is to

put on the one-size-fits-all Golden Straitjacket which virtually all the successful economies have allegedly worn on their way to prosperity.

In this chapter, I have shown that the TINA conclusion stems from a fundamentally defective understanding of the forces driving globalization and a distortion of history to fit the theory. Free trade was often imposed on, rather than chosen by, weaker countries.Most countries that had the choice did not choose free trade for more than brief periods.Virtually all successful economies, developed and developing, got where they are through selective, strategic integration with the world economy, rather than through unconditional global integration. The performance of the developing countries was much better when they had a large amount of policy autonomy during the 'bad old days' of state-led industrialization than when they were totally deprived of it during the first globalization (in the era of colonial rule and unequal treaties) or when they had much less policy autonomy (as in the past quarter of a century).

There is nothing inevitable about globalization, because it is driven more by politics (that is, human will and decision) than technology, as the Bad Samaritans claim. If it were technology that determined the extent of globalization, it would be impossible to explain how the world was much less globalized in the 1970s (when we had all the modern technologies of transport and communication except the internet) than in the 1870s (when we relied on steamships and wired telegraphy). Technology only defines the outer boundaries of globalization. Exactly what shape it takes depends on what we do with national policies and what international agreements we make. If that is the case, the TINA thesis is wrong. There is an alternative, or rather there are many alternatives, to the neo-liberal globalization that is happening today. The rest of this book is going to explore those alternatives.

* The idea behind import substitution industrialization is that a backward country starts producing industrial products that it used to import, thereby 'substituting' imported industrial products with domestically produced equivalents. This is achieved by making imports artificially expensive by means of tariffs and quotas against imports, or subsidies to domestic producers. The strategy was adopted by many Latin American countries in the 1930s. At the time, most other developing countries were not in a position to practise the ISI strategy, as they were either colonies or subject to 'unequal treaties' that deprived them of the right to set their own tariffs (see below). The ISI strategy was adopted by most other developing countries after they gained independence between the mid-1940s and the mid-1960s.

* These include the Asian Development Bank (ADB), the Inter-American Development Bank (IDB), the African Development Bank (AFDB) and the European Bank for Reconstruction and Development (EBRD), which deals with the former communist economies.

CHAPTER 2
The double life of Daniel Defoe

How did the rich countries become rich?

Daniel Defoe, the author of *Robinson Crusoe*, had a colourful life. Before writing novels, he was a businessman, importing woollen goods, hosiery, wine and tobacco. He also worked in the government in the royal lotteries and in the Glass Duty Office that collected the notorious 'window tax', a property tax levied according to the number of a house's windows. He was also an influential author of political pamphlets and led a double life as a government spy. First he spied for Robert Harley, the Tory speaker of the House of Commons. Later, he complicated his life even further by spying for the Whig government of Robert Walpole, Harley's political arch-enemy.

As if being a businessman, novelist, tax collector, political commentator and spy wasn't providing sufficient stimulus, Defoe was also an economist. This aspect of his life is even less well known than his spying. Unlike his novels, which include *Robinson Crusoe* and *Moll Flanders*, Defoe's main economic work, *A Plan of the English Commerce* (1728), is almost forgotten now. The popular biography of Defoe by Richard West does not mention the book at all, while the award-winning biography by Paula Backscheider mentions it largely in relation to marginal subjects, such as Defoe's view on native Americans.[1] However, the book was a thorough and insightful account of

Tudor industrial policy (under England's Tudor monarchs) that has much to teach us today.

In the book (henceforth *A Plan*), Defoe describes how the Tudor monarchs, especially Henry VII and Elizabeth I, used protectionism, subsidies, distribution of monopoly rights, government-sponsored industrial espionage and other means of government intervention to develop England's woollen manufacturing industry – Europe's high-tech industry at the time. Until Tudor times, Britain had been a relatively backward economy, relying on exports of raw wool to finance imports. The woollen manufacturing industry was centred in the Low Countries (today Belgium and the Netherlands), especially the cities of Bruges, Ghent and Ypres in Flanders. Britain exported its raw wool and made a reasonable profit. But those foreigners who knew how to convert the wool into clothes were generating much greater profits. It is a law of competition that people who can do difficult things which others cannot will earn more profit. This is the situation that Henry VII wanted to change in the late 15th century.[2]

According to Defoe, Henry VII sent royal missions to identify locations suited to woollen manufacturing.[3] Like Edward III before him, he poached skilled workers from the Low Countries.[4] He also increased the tax on the export of raw wool, and even temporarily banned its export, in order to encourage further processing of the raw material at home. In 1489, he also banned the export of unfinished cloth, save for coarse pieces below a certain market value, in order to promote further processing at home.[5] His son, Henry VIII, continued the policy and banned the export of unfinished cloth in 1512, 1513 and 1536.

As Defoe emphasizes, Henry VII did not have any illusions as to how quickly the English producers could catch up with their sophisticated competitors in the

Low Countries.[6] The King raised export duties on raw wool only when the English industry was established enough to handle the volume of wool to be processed. Henry then quickly withdrew his ban on raw wool exports when it became clear that Britain simply did not have the capacity to process all the raw wool it produced.[7] Indeed, according to *A Plan*, it was not until 1578, in the middle of Elizabeth I's reign (1558–1603) – nearly 100 years after Henry VII had started his 'import substitution industrialization' policy in 1489 – that Britain had sufficient processing capacity to ban raw wool exports totally.[8] Once in place, however, the export ban drove the competing manufacturers in the Low Countries, who were now deprived of their raw materials, to ruin.

Without the policies put in place by Henry VII and further pursued by his successors, it would have been very difficult, if not impossible, for Britain to have transformed itself from a raw-material exporter into the European centre of the then high-tech industry. Wool manufacture became Britain's most important export industry. It provided most of the export earnings to finance the massive import of raw materials and food that fed the Industrial Revolution.[9] *A Plan* shatters the foundation myth of capitalism that Britain succeeded because it figured out the true path to prosperity before other countries – free market and free trade.

Daniel Defoe's fictional hero, Robinson Crusoe, is often used by economics teachers as the pure example of 'rational economic man', the hero of neo-liberal free-market economics. They claim that, even though he lives alone, Crusoe has to make 'economic' decisions all the time. He has to decide how much to work in order to satisfy his desire for material consumption and leisure. Being a rational man, he puts in precisely the minimum amount of work to achieve the goal. Suppose

Crusoe then discovers another man living alone on a nearby island.How should they trade with each other? The free-market theory says that introducing a market (exchange) does not fundamentally alter the nature of Crusoe's situation. Life goes on much as before, with the additional consideration that he now needs to establish the rate of exchange between his product and his neighbour's. Being a rational man, he will continue to make the right decisions. According to free-market economics, it is precisely because we are like Crusoe that free markets work. We know exactly what we want and how best to achieve it. Consequently, leaving people to do what they desire and know to be good for themselves is the best way to run the economy. Government just gets in the way.

The kind of economics that underpins Defoe's *Plan* is exactly the opposite of Robinson Crusoe economics. In *A Plan*, Defoe clearly shows that it was not the free market but government protection and subsidies that developed British woollen manufacturing.Defying signals from the market that his country was an efficient raw wool producer and should remain so, Henry VII introduced policies that deliberately distorted such unwelcome notions. By doing so, he started the process that eventually transformed Britain into a leading manufacturing nation. Economic development requires people like Henry VII, who build a new future, rather than people like Robinson Crusoe, who live for today. Thus, in addition to his double life as a spy, Defoe also led a double life as an economist – without realizing it, he created the central character in free market economics in his fictional work, yet his own economic analysis clearly illustrated the limits of free market and free trade.

Britain takes on the world

Defoe started his double life as a spy for the Tory government, but later, as I mentioned, he spied for the Whig government of Robert Walpole. Walpole is commonly known as the first British prime minister, although he was never called that by his contemporaries.[10]

Walpole was notorious for his venality – he is said to have 'reduced corruption to a regular system'. He deftly juggled the disbursement of aristocratic titles, government offices and perks in order to maintain his power base, which enabled him to remain the prime minister for a staggering 21 years (1721–42). His political skills were immortalized by Jonathan Swift in his novel, *Gulliver's Travels*, in the character of Flimnap. Flimnap is the prime minister of the empire of Lilliput and champion of Dance of the Rope, the frivolous method by which the holders of high offices in Lilliput are selected.[11]

Yet Walpole was a highly competent economic manager. During his time as chancellor of the exchequer, he enhanced the creditworthiness of his government by creating a 'sinking fund' dedicated to repaying the debts. He became prime minister in 1721 because he was considered the only person who had the ability to manage the financial mess left behind by the infamous South Sea Bubble.[*]

Upon becoming prime minister, Walpole launched a policy reform that dramatically shifted the focus of British industrial and trade policies.Prior to Walpole, the British government's policies were, in general, aimed at capturing trade through colonization and the Navigation Act (which required that all trade with Britain should be conducted in British ships) and at generating government revenue. The promotion of woollen manufacturing was the most important exception, but even that was partly motivated by the desire to generate more government revenue. In contrast, the policies introduced by Walpole after 1721 were deliberately aimed at promoting manufacturing industries. Introducing the new law, Walpole stated, through the King's address to Parliament: 'it is evident that nothing so much contributes to promote the public well-being as the exportation of manufactured goods and the importation of foreign raw matrial'.[12]

Walpole's 1721 legislation essentially aimed to protect British manufacturing industries from foreign competition, subsidize them and encourage them to export.[13] Tariffs on imported foreign manufactured goods were significantly raised, while tariffs on raw materials used for manufacture were lowered, or even dropped altogether. Manufacturing exports were encouraged by a series of measures, including export subsidies.[14] Finally, regulation was introduced to control the quality of manufactured products, especially textile products, so that unscrupulous manufacturers could not damage the reputation of British products in foreign markets.[15]

These policies are strikingly similar to those used with such success by the 'miracle' economies of East Asia, such as Japan, Korea and Taiwan, after the Second World War. Policies that many believe, as I myself used to, to have been invented by Japanese policy-makers in the 1950s – such as 'duty drawbacks on inputs for exported manufactured products[*] and the imposition of export product quality standards by the government[†] – were actually early British inventions.[16]

Walpole's protectionist policies remained in place for the next century, helping British manufacturing industries catch up with and then finally forge ahead of their counterparts on the Continent. Britain remained a highly protectionist country until the mid-19th century. In 1820, Britain's average tariff rate on manufacturing

imports was 45–55%, compared to 6–8% in the Low Countries, 8–12% in Germany and Switzerland and around 20% in France.[17]

Tariffs were, however, not the only weapon in the arsenal of British trade policy. When it came to its colonies, Britain was quite happy to impose an outright ban on advanced manufacturing activities that it did not want developed. Walpole banned the construction of new rolling and slitting steel mills in America, forcing the Americans to specialize in low value-added pig and bar iron, rather than high value-added steel products.

Britain also banned exports from its colonies that competed with its own products, home and abroad. It banned cotton textile imports from India ('calicoes'), which were then superior to the British ones. In 1699 it banned the export of woollen cloth from its colonies to other countries (the Wool Act), destroying the Irish woollen industry and stifling the emergence of woollen manufacture in America.

Finally, policies were deployed to encourage primary commodity production in the colonies.Walpole provided export subsidies to (on the American side) and abolished import taxes on (on the British side) raw materials produced in the American colonies such as hemp, wood and timber.He wanted to make absolutely sure that the colonists stuck to producing primary commodities and never emerged as competitors to British manufacturers. Thus they were compelled to leave the most profitable 'high-tech' industries in the hands of Britain – which ensured that Britain would enjoy the benefits of being on the cutting edge of world development.[18]

The double life of the British economy

The world's first famous free-market economist, Adam Smith, vehemently attacked what he called the 'mercantile system' whose chief architect was Walpole. Adam Smith's masterpiece, *The Wealth of Nations*, was published in 1776, at the height of the British mercantile system. He argued that the restrictions on competition that the system was producing through protection, subsidies and granting of monopoly rights were bad for the British economy.*

Adam Smith understood that Walpole's policies were becoming obsolete. Without them, many British industries would have been wiped out before they had had the chance to catch up with their superior rivals abroad. But once British industries had become internationally competitive, protection became less necessary and even counter-productive. Protecting industries that do not need protection any more is likely to make them complacent and inefficient, as Smith observed. Therefore, adopting free trade was now increasingly in Britain's interest. However, Smith was somewhat ahead of his time. Another generation would pass before his views became truly influential, and it was not until 84 years after *The Wealth of Nations* was published that Britain became a genuine free trading nation.

By the end of the Napeolenic Wars in 1815, four decades after the publication of *The Wealth of Nations*, British manufacturers were firmly established as the most efficient in the world, except in a few limited areas where countries like Belgium and Switzerland possessed technological leads. British manufacturers correctly perceived that free trade was now in their interest and started campaigning for it (having said that, they naturally remained quite happy to restrict trade when it suited them, as the cotton manufacturers did when it came to the export of textile machinery that

might help foreign competitors). In particular, the manufacturers agitated for the abolition of the Corn Laws that limited the country's ability to import cheap grains. Cheaper food was important to them because it could lower wages and raise profits.

The anti-Corn Law campaign was crucially helped by the economist, politician and stock-market player, David Ricardo.Ricardo came up with the theory of comparative advantage that still forms the core of free trade theory. Before Ricardo, people thought foreign trade makes sense only when a country can make something more cheaply than its trading partner. Ricardo, in a brilliant inversion of this commonsensical observation, argued that trade between two countries makes sense even when one country can produce everything more cheaply than another. Although this country is more efficient in producing everything than the other, it can still gain by specializing in things in which it has the greatest cost advantage over its trading partner. Conversely, even a country that has no cost advantage over its trading partner in producing any product can gain from trade if it specializes in products in which it has the least cost disadvantage.With this theory, Ricardo provided the 19th-century free traders with a simple but powerful tool to argue that free trade benefits every country.

Ricardo's theory is absolutely right – within its narrow confines. His theory correctly says that, *accepting their current levels of technology as given*, it is better for countries to specialize in things that they are relatively better at. One cannot argue with that.

His theory fails when a country wants to acquire more advanced technologies so that it can do more difficult things that few others can do – that is, when it wants to develop its economy. It takes time and experience to absorb new technologies, so technologically backward producers need a period of protection from international competition during this period of learning. Such protection is costly, because the country is giving up the chance to import better and cheaper products. However, it is a price that has to be paid if it wants to develop advanced industries. Ricardo's theory is, thus seen, for those who accept the *status quo* but not for those who want to change it.

The big change in British trade policy came in 1846, when the Corn Laws were repealed and tariffs on many manufacturing goods were abolished. Free trade economists today like to portray the repeal of the Corn Laws as the ultimate victory of Adam Smith's and David Ricardo's wisdom over wrong-headed mercantilism.[19] The leading free trade economist of our time, Jagdish Bhagwati of Columbia University, calls this a 'historic transition'.[20]

However, many historians familiar with the period point out that making food cheaper was only one aim of the anti-Corn Law campaigners. It was also an act of 'free trade imperialism' intended to 'halt the move to industrialisation on the Continent by enlarging the market for agricultural produce and primary materials'.[21] By opening its domestic agricultural market wider, Britain wanted to lure its competitors back into agriculture. Indeed, the leader of the anti-Corn Law movement, Richard Cobden, argued that, without the Corn Laws: 'The factory system would, in all probability, not have taken place in America and Germany. It most certainly could not have flourished, as it has done, both in these states, and in France, Belgium and Switzerland, through the fostering bounties which the high-priced food of the British artisan has offered to the cheaper fed manufacturer of those countries'.[22] In the same spirit, in 1840, John Bowring of the Board of Trade, a key member of the

anti-Corn Law League, explicitly advised the member states of the German *Zollverein* (Custom Union) to specialize in growing wheat and sell the wheat to buy British manufactures.[23] Moreover, it was not until 1860 that tariffs were completely abolished. In other words, Britain adopted free trade only when it had acquired a technological lead over its competitors 'behind high and long-lasting tariff barriers', as the eminent economic historian Paul Bairoch once put it.[24] No wonder Friedrich List talked about 'kicking away the ladder'.

America enters the fray

The best critique of Britain's hypocrisy may have been written by a German, but the country that best resisted Britain's ladder-kicking in terms of policy was not Germany.Nor was it France, commonly known as the protectionist counterpoint to free-trading Britain. In fact, the counterbalance was provided by the US, Britain's former colony and today's champion of free trade.

Under British rule, America was given the full British colonial treatment. It was naturally denied the use of tariffs to protect its new industries. It was prohibited from exporting products that competed with British products. It was given subsidies to produce raw materials. Moreover, outright restrictions were imposed on what Americans could manufacture. The spirit behind this policy is best summed up by a remark William Pitt the Elder made in 1770. Hearing that new industries were emerging in the American colonies, he famously said: '[The New England] colonies should not be permitted to manufacture so much as a horseshoe nail'.[25] In reality, British policies were a little more lenient than this may imply: some industrial activities were permitted. But the manufacture of high-technology products was banned.

Not all Britons were as hard-hearted as Pitt. In recommending free trade to the Americans, some were convinced that they were helping them. In his *Wealth of Nations*, Adam Smith, the Scottish father of free market economics, solemnly advised the Americans not to develop manufacturing. He argued that any attempt to 'stop the importation of European manufactures' would 'obstruct instead of promoting the progress of their country towards real wealth and greatness'.[26]

Many Americans agreed, including Thomas Jefferson, the first secretary of state and the third president. But others fiercely disagreed. They argued that the country needed to develop manufacturing industries and use government protection and subsidies to that end, as Britain had done before them. The intellectual leader of this movement was a half-Scottish upstart called Alexander Hamilton.

Hamilton was born on the Caribbean island of Nevis, the illegitimate child of a Scottish pedlar (who dubiously claimed an aristocratic lineage) and a woman of French descent. He climbed to power thanks to his sheer brilliance and boundless energy. At 22, he was an aide-de-camp to George Washington in the War of Independence. In 1789, at the outrageously early age of 33, he became the country's first treasury secretary.

In 1791, Hamilton submitted his *Report on the Subject of Manufactures* (henceforth the *Report*) to the US Congress. In it, he expounded his view that the country needed a big programme to develop its industries. The core of his idea was that a backward country like the US should protect its 'industries in their infancy' from foreign competition and nurture them to the point where they could stand on their own feet. In recommending such a course of action for his young country, the impudent 35-year-old finance

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minister with only a liberal arts degree from a then second-rate college (King's College of New York, now Columbia University) was openly going against the advice of the world's most famous economist, Adam Smith.

The practice of protecting 'infant industries' had existed before, as I have shown, but it was Hamilton who first turned it into a theory and gave it a name (the term 'infant industry' was invented by him). The theory was later further developed by Friedrich List, who is today often mistakenly known as its father. List actually started out as a free-trader; he was one of the leading promoters of one of world's first free trade agreements – the German *Zollverein*, or Customs Union. He learned the infant industry argument from the Americans during his political exile in the US in the 1820s. Hamilton's infant industry argument inspired many countries' economic development programmes and became the *bête noire* of free trade economists for generations to come.

In the *Report*, Hamilton proposed a series of measures to achieve the industrial development of his country, including protective tariffs and import bans; subsidies; export ban on key raw materials; import liberalization of and tariff rebates on industrial inputs; prizes and patents for inventions; regulation of product standards; and development of financial and transportation infrastructures.[27] Although Hamilton rightly cautioned against taking these policies too far, they are, nevertheless, a pretty potent and 'heretical' set of policy prescriptions. Were he the finance minister of a developing country today, the IMF and the World Bank would certainly have refused to lend money to his country and would be lobbying for his removal from office.

Congress's action following Hamilton's *Report* fell far short of his recommendations, largely because US politics at the time were dominated by Southern plantation owners with no interest in developing American manufacturing industries. Quite understandably, they wanted to be able to import higher-quality manufactured products from Europe at the lowest possible price with the proceeds they earned from exporting agricultural products. Following Hamilton's *Report*, the average tariff on foreign manufactured goods was raised from around 5% to around 12.5%, but it was far too low to induce those buying manufactured goods to support the nascent American industries.

Hamilton resigned as treasurey secretary in 1795, following the scandal surrounding his extra-marital affair with a married woman, without the chance to further advance his programme. The life of this brilliant if caustic man was cut short in his 50th year (1804) in a pistol duel in New York, to which he was challenged by his friend-turned-political rival, Aaron Burr, the then vice president under Thomas Jefferson.[28] Had he lived for another decade or so, however, Hamilton would have been able to see his programme adopted in full.

When the War of 1812 broke out the US Congress immediately doubled tariffs from the average of 12.5% to 25%. The war also made the space for new industries to emerge by interrupting the manufactured imports from Britain and the rest of Europe. The new group of industrialists who had now arisen naturally wanted the protection to continue, and, indeed, to be increased, after the war.[29] In 1816, tariffs were raised further, bringing up the average to 35%.By 1820, the average tariff rose further to 40%, firmly establishing Hamilton's programme.

Hamilton provided the blueprint for US economic policy until the end of the Second World War. His

infant industry programme created the condition for a rapid industrial development. He also set up the government bond market and promoted the development of the banking system (once again, against opposition from Thomas Jefferson and his followers).[30] It is no hyperbole for the New-York Historical Society to have called him 'The Man Who Made Modern America' in a recent exhibition.[31] Had the US rejected Hamilton's vision and accepted that of his archrival, Thomas Jefferson, for whom the ideal society was an agrarian economy made up of self-governing yeoman farmers (although this slave-owner had to sweep the slaves who supported this lifestyle under the carpet), it would never have been able to propel itself from being a minor agrarian power rebelling against its powerful colonial master to the world's greatest super-power.

Abraham Lincoln and America's bid for supremacy

Although Hamilton's trade policy was well established by the 1820s, tariffs were an ever-present source of tension in US politics for the following three decades. The Southern agrarian states constantly attempted to lower industrial tariffs, while the Northern manufacturing states argued the case for keeping them high or even raising them further. In 1832, pro-free trade South Carolina even refused to accept the new federal tariff law, causing a political crisis. The so-called Nullification Crisis was resolved by President Andrew Jackson, who offered some tariff reduction (though not a lot, despite his image as the folk hero of American free market capitalism), while threatening South Carolina with military action. This served to patch things up temporarily, but the festering conflict eventually came to a violent resolution in the Civil War that was fought under the presidency of Abraham Lincoln.

Many Americans call Abraham Lincoln, the 16th president (1861–5), the Great Emancipator – of the American slaves. But he might equally be labelled the Great Protector – of American manufacturing. Lincoln was a strong advocate of infant industry protection. He cut his political teeth under Henry Clay of the Whig Party, who advocated the building of the 'American System', which consisted of infant industry protection ('Protection for Home Industries', in Clay's words) and investment in infrastructure such as canals ('Internal Improvements').[32] Lincoln, born in the same state of Kentucky as Clay, entered politics as a Whig state lawmaker of Illinois in 1834 at the age of 25, and was Clay's trusted lieutenant in the early days of his political career.

The charismatic Clay stood out from early on in his career. Almost as soon as he was elected to Congress in 1810, he became the Speaker of the House (from 1811 until 1820 and then again in 1823–5). As a politician from the West, he wanted to persuade the Western states to join forces with the Northern states, in the development of whose manufacturing industries Clay saw the future of his country. Traditionally, the Western states, having little industry, had been advocates of free trade and thus allied themselves with the pro-free trade Southern states. Clay argued that they should switch sides to back a protectionist programme of industrial development in return for federal investments in infrastructure to develop the region. Clay ran for the presidency three times (1824, 1832 and 1844) without success, although he came very close to winning the popular vote in the 1844 election. The Whig candidates who did manage to become presidents – William Harrison (1841–4) and Zachary Taylor (1849–51) – were generals with no clear political

or economic views.

In the end, what made it possible for the protectionists to win the presidency with Lincoln as their candidate was the formation of the Republican Party. Today the Republican Party calls itself the GOP (Grand Old Party), but it is actually younger than the Democratic Party, which has existed in one form or another since the days of Thomas Jefferson (when it was called, somewhat confusingly to the modern observer, the Democratic Republicans). The Republican Party was a mid-19th-century invention, based on a new vision that befitted a country that was rapidly moving outward (into the West) and forward (through industrialization), rather than harking back to an increasingly unsustainable agrarian economy based on slavery.

The winning formula that the Republican Party came up with was to combine the American System of the Whigs with the free distribution of public land (often already illegally occupied) so strongly wanted by the Western states. This call for free distribution of public land was naturally anathema to the Southern landlords, who saw it as the start of a slippery slope towards a comprehensive land reform. The legislation for such distribution had been constantly thwarted by the Southern Congressmen. The Republican Party undertook to pass the Homestead Act, which promised to give 160 acres of land to any settler who would farm it for five years. This act was passed during the Civil War in 1862, by which time the South had withdrawn from Congress.

Slavery was *not* as divisive an issue in pre-Civil-War US politics as most of us today believe it to have been. Abolitionists had a strong influence in some Northern states, especially Massachusetts, but the mainstream Northern view was not abolitionist.Many people who were opposed to slavery thought that black people were racially inferior and thus were against giving them full citizenship, including the right to vote. They believed the proposal by radicals for an immediate abolition of slavery to be highly unrealistic. The Great Emancipator himself shared these views. In response to a newspaper editorial urging immediate slave emancipation, Lincoln wrote: 'If I could save the Union without freeing any slave, I would do it; and if I could save it by freeing all the slaves, I would do it; and if I could do it by freeing some and leaving others alone, I would also do that'.[33] Historians of the period agree that his abolition of slavery in 1862 was more of a strategic move to win the war than an act of moral conviction. Disagreement over trade policy, in fact, was at least as important as, and possibly more important than, slavery in bringing about the Civil War.

During the 1860 election campaign, the Republicans in some protectionist states assailed the Democrats as a 'Southern-*British*-Antitariff-Disunion party [my italics]', playing on Clay's idea of the *American* system which implied that free trade was in the British, not American, interest.[34] However, Lincoln tried to keep quiet on the tariff issue during the election campaign, not just to avoid attacks from the Democrats but also to keep the fragile new party united, as there were some free-traders in the party (mostly former Democrats who were anti-slavery).

But, once elected, Lincoln raised industrial tariffs to their highest level so far in US history.[35] The expenditure for the Civil War was given as an excuse – in the same way in which the first significant rise in US tariffs came about during the Anglo-American War (1812–16). However, after the war, tariffs stayed at wartime levels or above. Tariffs on manufactured imports remained at 40–50% until the First World

War, and were the highest of any country in the world.[36]

In 1913, following the Democratic electoral victory, the Underwood Tariff bill was passed, reducing the average tariff on manufactured goods from 44% to 25%.[37] But tariffs were raised again very soon afterwards, thanks to American participation in the First World War. After the Republican return to power in 1921, tariffs went up again, although they did not go back to the heights of the 1861–1913 period. By 1925, the average manufacturing tariff had climbed back up to 37%. Following the onset of the Great Depression, there came the 1930 Smooth-Hawley tariff, which raised tariffs even higher.

Along with the much-trumpeted wisdom of the Anti-Corn Law movement, the stupidity of the Smoot-Hawley tariff has become a key fable in free trade mythology. Jagdish Bhagwati has called it 'the most visible and dramatic act of anti-trade folly'.[38] But this view is misleading. The Smoot-Hawley tariff may have provoked an international tariff war, thanks to bad timing, especially given the new status of the US as the world's largest creditor nation after the First World War. But it was simply not the radical departure from the country's traditional trade policy stance that free trade economists claim it to have been. Following the bill, the average industrial tariff rate rose to 48%. The rise from 37% (1925) to 48% (1930) is not exactly small but it is hardly a seismic shift. Moreover, the 48% obtained after the bill comfortably falls within the range of the rates that had prevailed in the country ever since the Civil War, albeit in the upper region thereof.

Despite being the most protectionist country in the world throughout the 19th century and right up to the 1920s, the US was also the fastest growing economy. The eminent Swiss economic historian, Paul Bairoch, points out that there is no evidence that the only significant reduction of protectionism in the US economy (between 1846 and 1861) had any noticeable positive impact on the country's rate of economic growth.[39] Some free trade economists argue that the US grew quickly during this period *despite* protectionism, because it had so many other favourable conditions for growth, particularly its abundant natural resources, large domestic market and high literacy rate.[40] The force of this counter-argument is diminished by the fact that, as we shall see, many other countries with few of those conditions also grew rapidly behind protective barriers. Germany, Sweden, France, Finland, Austria, Japan, Taiwan and Korea come to mind.

It was only after the Second World War that the US – with its industrial supremacy now unchallenged – liberalized its trade and started championing the cause of free trade. But the US has never practised free trade to the same degree as Britain did during its free trade period (1860 to 1932). It has never had a zero-tariff regime like Britain. It has also been much more aggressive in using non-tariff protectionist measures when necessary.[41] Moreover, even when it shifted to freer (if not absolutely free) trade, the US government promoted key industries by another means, namely, public funding of R&D. Between the 1950s and the mid-1990s, US federal government funding accounted for 50–70% of the country's total R&D funding, which is far above the figure of around 20%, found in such 'government-led' countries as Japan and Korea. Without federal government funding for R&D, the US would not have been able to maintain its technological lead over the rest of the world in key industries like computers, semiconductors, life sciences, the internet and aerospace.

Other countries, guilty secrets

Given that protectionism is bad for economic growth, how can the two most successful economies in history have been so protectionist? One possible answer is that, while Britain and the US were protectionist, they were economically more successful than other countries because they were less protectionist than others. Indeed, it seems likely that other rich countries known for their protectionist tendencies – such as France, Germany and Japan – had even higher tariff walls than those of Britain and the US.

This is not true. None of the other countries among today's wealthy nations were ever as protectionist as Britain or the US, with the brief exception of Spain in the 1930s.[42] France, Germany and Japan – the three countries that are usually considered to be the homes of protectionism – always had lower tariffs than Britain or the US (until the latter two countries converted to free trade following their economic ascendancy).

France is often presented as the protectionist counterpoint to free-trade Britain. But, between 1821 and 1875, especially up until the early 1860s, France had lower tariffs than Britain.[43] Even when it became protectionist – between the 1920s and the 1950s – its average industrial tariff rate was never over 30%. The average industrial tariff rates in Britain and the US were 50–55% at their heights.

Tariffs were always relatively low in Germany. Throughout the 19th and in the early 20th century (until the First World War), the average manufacturing tariff rate in Germany was 5–15%, way below the American and the British (before the 1860s) rates of 35–50%. Even in the 1920s, when it became more protective of its industries, Germany's average industrial tariff rate stayed around 20%. The frequent equation of fascism with protectionism in free trade mythology is highly misleading in this sense.

As for Japan, in the very early days of its industrial development, it actually practised free trade. But this was not out of choice but due to a series of unequal treaties that it was forced by Western countries to sign upon its opening in 1853. These treaties bound Japan's tariff rate below 5% until 1911. But, even after it regained tariff autonomy and raised manufacturing tariffs, the average industrial tariff rate was only about 30%.

It was only after the Second World War, when the US became top dog and liberalized its trade, that countries like France came to look protectionist. But, even then, the difference was not that great. In 1962, the average industrial tariff in the US was still 13%. With only 7% average industrial tariff rates, the Netherlands and West Germany were considerably less protectionist than the US. Tariff rates in Belgium, Japan, Italy, Austria and Finland were only slightly higher, ranging from 14% to 20%. France, with a tariff rate of 30% in 1959, was the one exception.[44] By the early 1970s, the US could not claim to be the leading practitioner of free trade any more. By then, other rich countries had caught up with it economically and found themselves able to lower their industrial tariffs. In 1973, the US average industrial tariff rate was 12%, compared to Finland's 13%, Austria's 11% and Japan's 10%. The average tariff rate of the EEC (European Economic Community) countries was considerably lower than the US rate, at only 8%.[45]

So the two champions of free trade, Britain and the US, were not only not free trade economies, but had been the two most protectionist economies among rich countries – that is, until they each in succession became the world's dominant industrial power.[*]

Of course, tariffs are only one of the many tools that a country can use to promote its infant industries. After all, Hamilton's original recommendation listed eleven types of measures to promote infant industry, including patents, product quality standards and public investment in infrastructure. Britain and the US may have used tariffs most aggressively, but other countries often used other means of policy intervention – for example, state-owned enterprises, subsidies or export marketing support – more intensively.

In the early days of their industrialization, when there were not enough private sector entrepreneurs who could take on risky, large-scale ventures, most of today's rich country governments (except the US and the British) set up state-owned enterprises. In some case, they provided so many subsidies and other help (e.g., poaching skilled workers from abroad) to some private-sector enterprises that they were effectively public-private joint ventures. In the 18th century, Prussia, the leader of German industrialization, promoted industries like linen, iron and steel by means of these methods. Japan started steel, shipbuilding and railway industries through state ownership and targeted subsidies (more on this in chapter 5). In the late 19th century, the Swedish government took the lead in developing the railways. As of 1913, it owned one-third of the railways in terms of mileage and 60% in terms of goods transported – this at a time when the leaders in railway development, namely Britain and the US, relied almost entirely on the private sector. Public-private co-operation in Sweden continued in the development of the telegraph, telephone and hydro-electric sectors. The Swedish government also subsidised R&D from early on.

After the Second World War, state efforts to promote industry were intensified in most rich countries. The biggest shift was in France. Contrary to the popular image, the French state has not always been interventionist. There certainly had been a tradition of state activism, represented by Jean-Baptiste Colbert, Louis XIV's long-time finance minister (1865–83), but it was rejected after the French Revolution. So, between the end of Napoleon's rule and the Second World War, except during the rule of Napoleon III, the French state took an extreme *laissez-faire* approach to economic policy. One major historical account of French economic policy points out that, during this period, the industrial promotion strategy of the French government 'consisted largely of organising exhibitions, looking after the Chambers of Commerce, gathering economic statistics, and distributing decorations to businessmen'.[46] After 1945, acknowledging that its conservative, hands-off policies were responsible for its relative economic decline and thus defeats in two world wars, the French state took a much more active role in the economy. It launched 'indicative' (as opposed to communism's 'compulsory') planning, took over key industries through nationalization, and channelled investment into strategic industries through state-owned banks. To create the breathing space for new industries to grow, industrial tariffs were maintained at a relatively high level until the 1960s. The strategy worked very well. By the 1980s, France had transformed itself into a technological leader in many areas.

In Japan, the famous MITI (Ministry of International Trade and Industry) orchestrated an industrial development programme that has now become a legend. Japan's industrial tariffs were not particularly high after the Second World War, but imports were tightly controlled through government control over foreign exchange. Exports were promoted

in order to maximize the supply of foreign currency needed to buy up better technology (either by buying machinery or by paying for technology licences). This involved direct and indirect export subsidies as well as information and marketing help from JETRO (Japan External Trade Organisation), the state trading agency. Japan took other measures to create the space needed for the accumulation of new productive capabilities by infant industries. The Japanese government channelled subsidized credits into key sectors through 'directed credit progammes'. It also heavily regulated foreign investment by transnational corporations (TNCs). Foreign investment was simply banned in most key industries. Even when it was allowed, there were strict ceilings on foreign ownership, usually a maximum of 49%. Foreign companies were required to transfer technology and buy at least specified proportions of their inputs locally (the so-called local contents requirement). The Japanese government also regulated the inflow of technologies, to make sure that obsolete or over-priced technologies were not imported. However, unlike in the 19th century, the Japanese government did not use SOEs in key manufacturing industries.

Countries like Finland, Norway, Italy and Austria – which were all relatively backward at the end of the Second World War and saw the need for rapid industrial development – also used strategies similar to those used by France and Japan to promote their industries. All of them had relatively high tariffs until the 1960s. They all actively used SOEs to upgrade their industries. This was particularly successful in Finland and Norway. In Finland, Norway and Austria, the government was very much involved in directing the flow of bank credit to strategic industries. Finland heavily controlled foreign investment. In many parts of Italy, local government provided support for marketing and R&D to small and medium-sized firms in the locality.

Thus practically all of today's rich countries used nationalistic policies (e.g., tariffs, subsidies, restrictions on foreign trade) to promote their infant industries, though the exact mix of policies used, as well as their timing and duration, differed across countries. There were some exceptions, notably the Netherlands (which has had the best free-trade credentials since the 19th century) and Switzerland (until the First World War) consistently practised free trade. But even they do not conform to today's neo-liberal ideal, as they did not protect patents until the early 20th century. The Netherlands introduced a patent law in 1817, but abolished it in 1869 and did not re-introduce it until 1912. The Swiss introduced their first patent law in 1888, but it protected only mechanical inventions. It introduced a full patent law only in 1907 (more on these cases in chapter 6).

Against the kind of historical evidence that I have presented in this chapter, free trade economists have argued that the mere co-existence of protectionism and economic development does not prove that the former caused the latter.[47] This is true. But I am at least trying to explain one phenomenon – economic development – with another that co-existed with it – protectionism. Free trade economists have to explain how free trade can be an explanation for the economic success of today's rich countries, when it simply had not been practised very much before they became rich.

Learning the right lessons from history

The Roman politician and philosopher Cicero once said: 'Not to know what has been transacted in former times is to be always a child. If no use is made of the

labours of past ages, the world must remain always in the infancy of knowledge.'

Nowhere is this observation more relevant than in the design of development policy, but nowhere is it more ignored. Though we have a wealth of historical experiences to draw upon, we do not bother to learn from them, and unquestioningly accept the prevailing myth that today's rich countries developed through free-trade, free-market policy.

But history tells us that, in the early stage of their development, virtually all successful countries used some mixture of protection, subsidies and regulation in order to develop their economies. The history of the successful developing countries that I discussed in chapter 1 shows that. Furthermore, the history of today's rich countries also confirms it, as I have discussed in this chapter.

Unfortunately, another lesson of history is that rich countries have 'kicked away the ladder' by forcing free-market, free-trade policies on poor countries.Already established countries do not want more competitors emerging through the nationalistic policies they themselves successfully used in the past. Even the newest member of the club of rich countries, my native Korea, has not been an exception to this pattern. Despite once having been one of the most protectionist countries in the world, it now advocates steep cuts in industrial tariffs, if not total free trade, in the WTO. Despite once having been the world piracy capital, it gets upset that the Chinese and the Vietnamese are producing pirate CDs of Korean pop music and pirate DVDs of Korean movies. Worse, these Korean free-marketeers are often the same people who, not so long ago, actually drafted and implemented interventionist, protectionist policies in their earlier jobs.Most of them probably learned their free market economics from pirate-copied American economics textbooks, while listening to pirate-copied rock and roll music and watching pirate-copied videos of Hollywood films in their spare time.

Even more prevalent and important than 'ladder-kicking', however, is historical amnesia. In the Prologue, I explained the gradual and subtle process in which history is re-written to fit a country's present self-image. As a result, many rich country people recommend free-trade, free-market policies in the honest belief that these are policies that their own ancestors used in order to make their countries rich. When the poor countries protest that those policies hurt, those protests are dismissed as being intellectually misguided[48] or as serving the interests of their corrupt leaders.[49] It never occurs to those Bad Samaritans that the policies they recommend are fundamentally at odds with what history teaches us to be the best development policies. The intention behind their policy recommendations may be honourable, but their effects are no less harmful than those from policy recommendations motivated by deliberate ladder-kicking.

Fortunately, history also shows that it is not inevitable that successful countries act as Bad Samaritans, and, more importantly, that it is in their enlightened self-interest not to. The most recent and important episode of this kind occurred between the launch of the Marshall Plan in 1947 and the rise of neo-liberalism in the 1980s.

In June 1947, the US abandoned its previous policy of deliberately weakening the German economy and launched the Marshall Plan, which channelled a large amount of money into European post-war reconstruction.[*] Even though the sum involved in this was not huge, the Marshall Plan played an important

role in kickstarting the war-torn European economies by financing essential import bills and financing the re-building of infrastructure. It was a political signal that the US saw it in its interest that other nations, even its former enemies, prosper. The US also led other rich countries in helping, or at least allowing, poor countries develop their economies through nationalistic policies. Through the GATT (General Agreement on Tariffs and Trade), also set up in 1947, the US and other rich countries allowed developing countries to protect and subsidize their producers more actively than the rich countries. This was a huge contrast to the days of colonialism and unequal treaties, when developing countries were forced into free trade. This was partly due to the sense of colonial guilt in countries like Britain and France, but it was mostly because of the more enlightened attitude of the then new hegemon of the global economy, the US, towards the economic development of poorer nations.

The result of this enlightened strategy was spectacular. The rich countries experienced the so-called 'Golden Age of Capitalism' (1950–73).[50] *Per capita* income growth rate in Europe shot up from 1.3% in the liberal golden age (1870–1913) to 4.1%. It rose from 1.8% to 2.5% in the US, while it skyrocketed from 1.5% to 8.1% in Japan. These spectacular growth performances were combined with low income inequality and economic stability. Significantly, developing countries also performed very well during this period. As I pointed out in chapter 1, during the 1960s and the 1970s, when they used nationalistic policies under the 'permissive' international system, they grew at 3% in *per capita* terms. This is way above what they had achieved under old liberal policies during 'first globalization' (1870–1913) and twice the rate they have recorded since the 1980s under neo-liberal policies.

Some have discounted the generosity of the US during the 1947–1979 period on the grounds that it was being nice to poor countries only because of the rivalry with the USSR in the Cold War. It would be silly to deny that the Cold War had an important influence on US foreign policy, but that should not stop us from giving credit where it is due. During the 'age of imperialism' in the late 19th and the early 20th century, the powerful countries behaved abominably towards the weaker countries *despite* the intense rivalry amongst themselves.

The history – recent and more distant – that I have discussed in the last two chapters will inform my discussion in the following chapters, where I explain how exactly today's Bad Samaritans are wrong in relation to the key areas of economic policy – international trade, foreign investment regulation, privatisation, protection of intellectual property rights, like patents, and macroeconomic policy – and suggest how their behaviour should be changed if we are to promote economic development in poor countries.

* The South Sea Company was set up in 1711 by Robert Harley, Defoe's first spymaster, and was granted exclusive trading rights in Spanish South America. It made little actual profit, but talked up its stock with the most extravagant rumours of the value of its potential trade. A speculative frenzy developed around its shares in 1720, with its stock price rising by ten times in seven months between January and August 1720. The stock price then started falling and, by early 1721, was back where it had been in January 1720.

* This is a practice where a manufacturer exporting a product is paid back the tariff that it has paid for the imported inputs used in producing the product. This is a way of encouraging exports.

† This is a practice where the government sets the minimum quality standards for export products and punishes those exporters who do not meet them. This is intended to prevent substandard export products tarnishing the image of the exporting country. It is particularly useful when products do not have well-recognized brand names and, therefore, are identified by their national origin.

* However, Smith was a patriot even more than he was a free market economist. He supported free market and free trade only because he thought they were good for Britain, as we can see from his praise of the Navigation Acts – the most blatant kind of 'market-distorting' regulation – as 'the wisest of all the commercial regulations of England'.

* The average tariff rate, of course, does not tell us the full story. A country may have a relatively low average tariff rate, but this could be the result of the heavy protection of certain sectors counterbalanced by very low or zero tariffs in other sectors. For example, during the late 19th and the early 20th century, while maintaining a relatively moderate *average* industrial tariff rate (5–15%), Germany accorded strong tariff protection to strategic industries like iron and steel. During the same period, Sweden also provided high protection to its newly emerging engineering industries, although its average tariff rate was 15–20%. In the first half of the 20th century, Belgium maintained moderate levels of overall protection (around 10% average industrial tariff rate), but heavily protected key textile sectors (30–60%) and the iron industry (85%).

* The Marshall Plan was announced by George Marshall, the then US secretary of state, in his address at Harvard University on 5 June 1947. Its details were negotiated in a meeting held in Paris from 12 July 1947. It was started in 1948 and ended in 1951, channelling

some $13 billion (equivalent to $130 billion today) into the war-torn economies of Europe. The Marshall Plan replaced the Morgenthau Plan that had dictated postwar American foreign policy until then. The Morgenthau Plan, named after the treasury secretary of the time (1934–45), focused on putting an end to Germany's expansionist ambition by 'pastoralizing' it. When combined with the Soviet Union's desire to seize advanced German machinery, it was very effective in destroying the German economy. However, it soon became obvious that such a plan was unviable. After his visit to Germany in 1947, the former US president Herbert Hoover denounced the Morgenthau Plan as 'illusory', and argued that it would not work unless the German population was reduced by 25 million, from 65 million to 40 million. For an enlightening discussion on the subject, see E. Reinert (2003), 'Increasing Poverty in a Globalised World: *Marshall Plans* and *Morgenthau Plans* as Mechanisms of Polarisation ofWorld Incomes' in H-J. Change (ed.), *Rethinking Development Economics* (Anthem Press, London).

CHAPTER 3
My six-year-old son should get a job

Is free trade always the answer?

I have a six-year-old son. His name is Jin-Gyu. He lives off me, yet he is quite capable of making a living. I pay for his lodging, food, education and health care. But millions of children of his age already have jobs. Daniel Defoe, in the 18th century, thought that children could earn a living from the age of four.

Moreover, working might do Jin-Gyu's character a world of good. Right now he lives in an economic bubble with no sense of the value of money. He has zero appreciation of the efforts his mother and I make on his behalf, subsidizing his idle existence and cocooning him from harsh reality. He is over-protected and needs to be exposed to competition, so that he can become a more productive person. Thinking about it, the more competition he is exposed to and the sooner this is done, the better it will be for his future development. It will whip him into a mentality that is ready for hard work. I should make him quit school and get a job. Perhaps I could move to a country where child labour is still tolerated, if not legal, to give him more choice in employment.

I can hear you say I must be mad. Myopic. Cruel. You tell me that I need to protect and nurture the child. If I drive Jin-Gyu into the labour market at the age of six, he may become a savvy shoeshine boy or even a prosperous street hawker, but he will never become a brain surgeon or a nuclear physicist – that would require at least another dozen years of my protection and investment. You argue that, even from a purely materialistic viewpoint, I would be wiser to invest in my son's education than gloat over the money I save by not sending him to school. After all, if I were right, Oliver Twist would have been better off pick-pocketing for Fagin, rather than being rescued by the misguided Good Samaritan Mr Brownlow, who deprived the boy of his chance to remain competitive in the labour market.

Yet this absurd line of argument is in essence how free-trade economists justify rapid, large-scale trade liberalization in developing countries. They claim that developing country producers need to be exposed to as much competition as possible right now, so that they have the incentive to raise their productivity in order to survive. Protection, by contrast, only creates complacency and sloth. The earlier the exposure, the argument goes, the better it is for economic development.

Incentives, however, are only half the story. The other is capability. Even if Jin-Gyu were to be offered a £20m reward or, alternatively, threatened with a bullet in his head, he would not be able to rise to the challenge of brain surgery had he quit school at the age of six. Likewise, industries in developing countries will not survive if they are exposed to international competition too early. They need time to improve their capabilities by mastering advanced technologies and building effective organizations. This is the essence of the infant industry argument, first theorized by Alexander Hamilton, first treasury secretary of the US, and used by generations of policy-makers before and after him, as I have just shown in the previous chapter.

Naturally, the protection I provide to Jin-Gyu (as the infant industry argument itself says) should not be used to shelter him from competition forever. Making him work at the age of six is wrong, but so is subsidizing him at the age of 40. Eventually he should go out into

the big wide world, get a job and live an independent life. He only needs protection while he is accumulating the capabilities to take on a satisfying and well-paid job.

Of course, as happens with parents bringing up their children, infant industry protection can go wrong. Just as some parents are over-protective, governments can cosset infant industries too much. Some children are unwilling to prepare themselves for adult life, just as infant industry support is wasted on some firms. In the way that some children manipulate their parents into supporting them beyond childhood, there are industries that prolong government protection through clever lobbying. But the existence of dysfunctional families is hardly an argument against parenting itself. Likewise, cases of failures in infant industry protection cannot discredit the strategy *per se*. The examples of bad protectionism merely tell us that the policy needs to be used wisely.

Free trade isn't working

Free trade is good – this is the doctrine at the heart of the neo-liberal orthodoxy. To the neo-liberals, there cannot be a more self-evident proposition than this. Professor Willem Buiter, my distinguished former colleague at Cambridge and a former chief economist of the EBRD (European Bank for Reconstruction and Development), once expressed this succinctly:'Remember: unilateral trade liberalization is not a "concession" or a "sacrifice" that one should be compensated for. It is an act of enlightened self-interest. Reciprocal trade liberalization enhances the gains but is not necessary for gains to be present. The economics is all there'.[1] Belief in the virtue of free trade is so central to the neo-liberal orthodoxy that it is effectively what defines a neo-liberal economist. You may question (if not totally reject) any other element of the neo-liberal agenda – open capital markets, strong patents or even privatisation – and still stay in the neo-liberal church. However, once you object to free trade, you are effectively inviting ex-communication.

Based on such convictions, the Bad Samaritans have done their utmost to push developing countries into free trade – or, at least, much freer trade. During the past quarter of a century, most developing countries have liberalized trade to a huge degree. They were first pushed by the IMF and the World Bank in the aftermath of the Third World debt crisis of 1982. There was a further decisive impetus towards trade liberalization following the launch of the WTO in 1995. During the last decade or so, bilateral and regional free trade agreements (FTAs) have also proliferated.Unfortunately, during this period, developing countries have not done well at all, despite (or because of, in my view) massive trade liberalization, as I showed in chapter 1.

The story of Mexico – poster boy of the free-trade camp – is particularly telling. If any developing country can succeed with free trade, it should be Mexico. It borders on the largest market in the world (the US) and has had a free trade agreement with it since 1995 (the North American Free Trade Agreement or NAFTA). It also has a large diaspora living in the US, which can provide important informal business links.[2] Unlike many other poorer developing countries, it has a decent pool of skilled workers, competent managers and relatively developed physical infrastructure (roads, ports and so on).

Free trade economists argue that free trade benefited Mexico by accelerating growth. Indeed, following NAFTA, between 1994 and 2002, Mexico's *per capita* GDP grew at 1.8% per year, a big improvement over the 0.1% rate recorded between 1985

and 1995.[3] But the decade before NAFTA was also a decade of extensive trade liberalisation for Mexico, following its conversion to neo-liberalism in the mid-1980s. So trade liberalization was also responsible for the 0.1% growth rate.

Wide-ranging trade liberalization in the 1980s and the 1990s wiped out whole swathes of Mexican industry that had been painstakingly built up during the period of import substitution industrialization (ISI). The result was, predictably, a slowdown in economic growth, lost jobs and falls in wages (as better-paying manufacturing jobs disappeared). Its agricultural sector was also hard hit by subsidized US products, especially corn, the staple diet of most Mexicans. On top of that, NAFTA's positive impact (in terms of increasing exports to the US market) has run out of steam in the last few years. During 2001–2005, Mexico's growth performance has been miserable, with an annual growth rate of *per capita* income at 0.3% (or a paltry 1. 7% increase in total over five years).[4] By contrast, during the 'bad old days' of ISI (1955–82), Mexico's *per capita* income had grown much faster than during the NAFTA period – at an average of 3.1% per year.[5]

Mexico is a particularly striking example of the failure of premature wholesale trade liberalization, but there are other examples.[6] In Ivory Coast, following tariff cuts of 40% in 1986, the chemical, textile, shoe and automobile industries virtually collapsed. Unemployment soared. In Zimbabwe, following trade liberalization in 1990, the unemployment rate jumped from 10% to 20%. It had been hoped that the capital and labour resources released from the enterprises that went bankrupt due to trade liberalization would be absorbed by new businesses. This simply did not happen on a sufficient scale. It is not surprising that growth evaporated and unemployment soared.

Trade liberalization has created other problems, too. It has increased the pressures on government budgets, as it reduced tariff revenues. This has been a particularly serious problem for the poorer countries. Because they lack tax collection capabilities and because tariffs are the easiest tax to collect, they rely heavily on tariffs (which sometimes account for over 50% of total government revenue).[7] As a result, the fiscal adjustment that has had to be made following large-scale trade liberalization has been huge in many developing countries – even a recent IMF study shows that, in low-income countries that have limited abilities to collect other taxes, *less than 30%* of the revenue lost due to trade liberalization over the last 25 years has been made up by other taxes.[8] Moreover, lower levels of business activity and higher unemployment resulting from trade liberalization have also reduced income tax revenue.When countries were already under considerable pressure from the IMF to reduce their budget deficits, falling revenue meant severe cuts in spending, often eating into vital areas like education, health and physical infrastructure, damaging long-term growth.

It is perfectly possible that *some* degree of *gradual* trade liberalization may have been beneficial, and even necessary, for certain developing countries in the 1980s – India and China come to mind. But what has happened during the past quarter of a century has been a rapid, unplanned and blanket trade liberalization. Just to remind the reader, during the 'bad old days' of protectionist import substitution industrialization (ISI), developing countries used to grow, on average, at double the rate that they are doing today under free trade. Free trade simply isn't working for developing countries.

Poor theory, poor results

Free trade economists find all this quite mysterious. How can countries do badly when they are using such theoretically well-proven ('the economics is all there', as Professor Buiter says) policy as free trade? But they should not be surprised. For their theory has some serious limitations.

Modern free trade argument is based on the so-called Heckscher-Ohlin-Samuelson theory (or the HOS theory).[*] The HOS theory derives from David Ricardo's theory, which I outlined in chapter 2, but it differs from Ricardo's theory in one crucial respect. It assumes that comparative advantage arises from international differences in the relative endowments of 'factors of production' (capital and labour), rather than international differences in technology, as in Ricardian theory.[9]

According to free trade theory, be it Ricardian or the HOS version, every country has a comparative advantage in some products, as it is, by definition, *relatively* better at producing some things than others.[†] In the HOS theory, a country has comparative advantage in products that more intensively use the factor of production with which it is relatively more richly endowed. So even if Germany, a country relatively richer in capital than labour, can produce *both* automobiles *and* stuffed toys more cheaply than Guatemala, it pays for it to specialize in automobiles, as their production uses capital more intensively. Guatemala, even if it is less efficient in producing both automobiles and stuffed toys than Germany, should still specialize in stuffed toys, whose production uses more labour than capital.

The more closely a country conforms to its underlying pattern of comparative advantage, the more it can consume. This is possible due to the increase in its own production (of the goods for which it has comparative advantage), and, more importantly, due to increased trading with other countries that specialize in different products.How can the country achieve this? By leaving things as they are.When they are free to choose, firms will rationally (like Robinson Crusoe) specialize in things that they are relatively good at and trade with foreigners. From this follows the propositions that free trade is best and that trade liberalization, even when it is unilateral, is beneficial.

But the conclusion of the HOS theory critically depends on the assumption that productive resources can move freely across economic activities. This assumption means that capital and labour released from any one activity can immediately and without cost be absorbed by other activities.With this assumption – known as the assumption of 'perfect factor mobility' among economists – adjustments to changing trade patterns pose no problem. If a steel mill shuts down due to an increase in imports because, say, the government reduces tariffs, the resources employed in the industry (the workers, the buildings, the blast furnaces) will be employed (at the same or higher levels of productivity and thus higher returns) by another industry that has become relatively more profitable, say, the computer industry. No one loses from the process.

In reality, this is not the case: factors of production cannot take any form as it becomes necessary. They are usually fixed in their physical qualities and there are few 'general use'machines or workers with a 'general skill' that can be used across industries. Blast furnaces from a bankrupt steel mill cannot be re-moulded into a machine making computers; steel workers do not have the right skills for the computer industry.Unless they

are retrained, the steel workers will remain unemployed. At best, they will end up working in low-skill jobs, where their existing skills are totally wasted. This point is poignantly made by the British hit comedy film of 1997, *The Full Monty*, where six unemployed steel workers from Sheffield struggle to rebuild their lives as male strippers. There are clearly winners and losers involved in changing trade patterns, whether it is due to trade liberalization or to the rise of new, more productive foreign producers.

Most free trade economists would accept that there are winners and losers from trade liberalization but argue that their existence cannot be an argument against trade liberalization. Trade liberalization brings overall gains. As the winners gain more than what is lost by the losers, the winners can make up all the latter's losses and still have something left for themselves. This is known as the 'compensation principle' – if the winners from an economic change can fully compensate the losers and still have something left, the change is worth making.

The first problem with this line of argument is that trade liberalization does *not* necessarily bring overall gain. Even if there are winners from the process, their gains may not be as large as the losses suffered by the losers – for example, when trade liberalization reduces the growth rate or even make the economy shrink, as has happened in many developing countries in the past two decades.

Moreover, even if the winners gain more than the losers lose, the compensation is not automatically made through the workings of the market, which means that some people will be worse off than before. Trade liberalization will benefit everyone only when the displaced workers can get better (or at least equally good) jobs quickly, and when the discharged machines can be re-shaped into new machines – which is rarely.

This is a more serious problem in developing countries, where the compensation mechanism is weak, if not non-existent. In developed countries, the welfare state works as a mechanism to partially compensate the losers from the trade adjustment process through unemployment benefits, guarantees of health care and education, and even guarantees of a minimum income. In some countries, such as Sweden and other Scandinavian countries, there are also highly effective retraining schemes for unemployed workers so that they can be equipped with new skills. In most developing countries, however, the welfare state is very weak and sometimes virtually non-existent. As a result, the victims of trade adjustment in these countries do not get even partially compensated for the sacrifice that they have made for the rest of society.

As a result, the gains from trade liberalization in poor countries are likely to be more unevenly distributed than in rich countries. Especially when considering that many people in developing countries are already very poor and close to the subsistence level, large-scale trade liberalization carried out in a short period of time will mean that some people have their livelihoods wrecked. In developed countries, unemployment due to trade adjustment may not be a matter of life and death, but in developing countries it often is. This is why we need to be more cautious with trade liberalization in poorer economies.

The short-run trade adjustment problem arising from the immobility of economic resources and the weakness of compensating mechanisms is, although serious, only a secondary problem with free trade theory. The more serious problem – at least for an economist like myself – is that the theory is about efficiency in the short-run use of given resources, and

not about increasing available resources through economic development in the long run; contrary to what their proponents would have us believe, free trade theory does *not* tell us that free trade is good for *economic development*.

The problem is this – producers in developing countries entering new industries need a period of (partial) insulation from international competition (through protection, subsidies and other measures) before they can build up their capabilities to compete with superior foreign producers. Of course, when the infant producers 'grow up' and are able to compete with the more advanced producers, the insulation should go. But this has to be done gradually. If they are exposed to too much international competition too soon, they are bound to disappear. That is the essence of the infant industry argument that I set out at the beginning of the chapter with a little help from my son, Jin-Gyu.

In recommending free trade to developing countries, the Bad Samaritans point out that all the rich countries have free(ish) trade. This is, however, like people advising the parents of a six-year-old boy to make him get a job, arguing that successful adults don't live off their parents and, therefore, that being independent must be the reason for their successes. They do not realize that those adults are independent *because* they are successful, and not the other way around. In fact, most successful people are those who have been well supported, financially and emotionally, by their parents when they were children. Likewise, as I discussed in chapter 2, the rich countries liberalized their trade only when their producers were ready, and usually only gradually even then. In other words, historically, trade liberalization has been the *outcome* rather than the *cause* of economic development.

Free trade may often – although not always – be the best trade policy *in the short run*, as it is likely to maximize a country's current consumption. But it is definitely not the best way to develop an economy. In the long run, free trade is a policy that is likely to condemn developing countries to specialize in sectors that offer low productivity growth and thus low growth in living standards. This is why so few countries have succeeded with free trade, while most successful countries have used infant industry protection to one degree or another. Low income that results from lack of economic development severely restricts the freedom that the poor countries have in deciding their future. Paradoxically, therefore, 'free' trade policy reduces the 'freedom' of the developing countries that practise it.

The international trading system and its discontents

Never mind that free trade works neither in practice nor in theory. Despite its abysmal record, the Bad Samaritan rich countries have strongly promoted trade liberalization in developing since the 1980s.

As I discussed in the earlier chapters, the rich countries had been quite willing to let poor countries use more protection and subsidies until the late 1970s. However, this began to change in the 1980s. The change was most palpable in the US, whose enlightened approach to international trade with economically lesser nations rapidly gave way to a system similar to 19th-century British 'free trade imperialism'. This new direction was clearly expressed by the then US president Ronald Reagan in 1986, as the Uruguay Round of GATT talks was starting, when he called for 'new and more liberal agreements with our trading partners – agreement under which they would fully open their markets and treat American products as they

treat their own'.[10] Such agreement was realized through the Uruguay Round of GATT trade talks, which started in the Uruguayan city of Punta del Este in 1986 and was concluded in the Moroccan city of Marrakech in 1994. The result was the World Trade Organisation regime – a new international trade regime that was much more biased against the developing countries than the GATT regime.

On the surface, the WTOsimply created a 'level playing field'among its member countries, requiring that everyone plays by the same rule – how can we argue against that? Critical to the process was the adoption of the principle of a 'single undertaking', which meant that all members had to sign up to all agreements. In the GATT regime, countries could pick and choose the agreements that they signed up to and many developing countries could stay out of agreements that they did not want – for example, the agreement restricting the use of subsidies. With the single undertaking, all members had to abide by the same rules. All of them had to reduce their tariffs. They were made to give up import quotas, export subsidies (allowed only for the poorest countries) and most domestic subsidies. But, when we look at the detail, we realize that the field is not level at all.

To begin with, even though the rich countries have low average protection, they tend to disproportionately protect products that poor countries export, especially garments and textiles. This means that, when exporting to a rich country market, poor countries face higher tariffs than other rich countries. An Oxfam report points out that 'The overall import tax rate for the USA is 1.6 per cent. That rate rises steeply for a large number of developing countries: average import taxes range from around four per cent for India and Peru, to seven per cent for Nicaragua, and as much as 14–15 per cent for Bangladesh, Cambodia and Nepal.'[11] As a result, in 2002, India paid more tariffs to the US government than Britain did, despite the fact that the size of its economy was less than one-third that of the UK. Even more strikingly, in the same year, Bangladesh paid almost as much in tariffs to the US government as France, despite the fact that the size of its economy was only 3% that of France.[12]

There are also structural reasons that make what looks like 'levelling the playing field' actually favour developed countries. Tariffs are the best example. The Uruguay Round resulted in all countries, except for the poorest ones, reducing tariffs quite a lot in proportional terms. But the developing countries ended up reducing their tariffs a lot more in absolute terms, for the simple reason that they started with higher tariffs. For example, before the WTO agreement, India had an average tariff rate of 71%. It was cut to 32%. The US average tariff rate fell from 7% to 3%. Both are similar in proportional terms (each representing around a 55% cut), but the absolute impact is very different. In the Indian case, an imported good that formerly cost $171 would now cost only $132 – a significant fall in what the consumer pays (about 23%) that would dramatically alter consumer behaviour. In the American case, the price the consumer pays would have fallen from $107 to $103 – a price difference that most consumers will hardly notice (less than 4%). In other words, the impact of tariff cuts of the same proportion is disproportionately larger for the country whose initial tariff rate is higher.

In addition, there were areas where 'levelling the playing field'meant a one-sided benefit to rich countries. The most important example is the TRIPS (Trade-related Intellectual Property Rights) agreement, which strengthened the protection of patents and other

intellectual property rights (more on this in chapter 6). Unlike trade in goods and services, where everyone has something to sell, this is an area where developed countries are almost always sellers and developing countries buyers. Therefore, increasing the protection for intellectual property rights means that the cost is mainly borne by the developing nations. The same problem applies to the TRIMS (Trade-related Investment Measures) agreement, which restricts the WTO member countries' ability to regulate foreign investors (more on this in chapter 4). Once again, most poor countries only receive, and do not make, foreign investment. So, while their ability to regulate foreign companies is reduced, they do not get 'compensated' by any reduction in the regulations that their national firms operating abroad are subject to, as they simply do not have such firms.

Many of the exceptions to the rules were created in areas where the developed countries needed them. For example, while most domestic subsidies are banned, subsidies are allowed in relation to agriculture, basic (as opposed to commercial) R&D (research and development), and reduction of regional disparities. These are all subsidies that happen to be extensively used by the rich countries. The rich nations give out an estimated $100 billion worth of agricultural subsidies every year; these include the $4 billion given to 25, 000 American peanut farmers and EU subsidies that allow Finland to produce sugar (from beets).[13] All rich country governments, especially the US government, heavily subsidize basic R&D, which then increases their competitiveness in related industries. Moreover, this is not a subsidy that developing nations can use, even if they are allowed to – they simply do not do much basic R&D, so there is little for them to subsidize. As for regional subsides, which have been extensively used by the European Union, this is another case of apparent neutrality really serving the interests mainly of rich countries. In the name of redressing regional imbalances, they have subsidized firms to induce them to locate in 'depressed' regions. Within the nation, this may be contributing to a reduction in regional inequality. But, when viewed from an international perspective, there is little difference between these subsidies and subsidies given to promote particular industries.

Against these accusations of 'levelling the playing field' only where it suits them, the rich countries often argue that they still give the developing countries 'special and differential treatment' (SDT). But special and differential treatment is now a pale shadow of what it used to be under the GATT regime. While some exceptions are made for the developing countries, especially the poorest ones ('the least developed countries' in WTO jargon), many of these exceptions were in the form of a slightly longer 'transition period' (five to ten years) before they reach the same final goal as the rich countries, rather than the offer of permanent asymmetrical arrangements.[14]

So, in the name of 'levelling the playing field', the Bad Samaritan rich nations have created a new international trading system that is rigged in their favour. They are preventing the poorer countries from using the tools of trade and industrial policies that they had themselves so effectively used in the past in order to promote their own economic development – not just tariffs and subsidies, but also regulation of foreign investment and 'violation' of foreign intellectual property rights, as I will show in subsequent chapters.

Industry for agriculture?

Not satisfied with the result of the Uruguay Round, the rich countries have been pushing for further liberalization by developing economies. There has been a push to tighten restrictions on controls over foreign investment, over and above what was accepted in the TRIMS agreement. This was attempted first through the OECD (in 1998) and then through the World Trade Organisation (in 2003).[15] The move was thwarted both times, so the developed countries have shifted their focus and are now concentrating on a proposal to drastically reduce industrial tariffs in the developing countries.

This proposal, dubbed NAMA (non-agricultural market access), was first launched in the Doha ministerial meeting of the World Trade Organisation in 2001. It got a critical impetus when, in December 2002, the US government dramatically upped the ante by calling for the abolition of all industrial tariffs by 2015.There are various proposals floating around, but, if the rich countries have their way in the NAMA negotiations, the tariff ceiling for developing economies could fall from the current 10–70% to 5–10% – a level that has not been seen since the days of the 'unequal treaties' in the 19th and early 20th centuries, when the weaker countries were deprived of tariff autonomy and forced to set a low, uniform tariff rate, typically 3–5%.

In return for developing countries cutting industrial tariffs, the rich countries promise that they will lower their agricultural tariffs and subsidies, so that the poor countries can increase their exports. This was sold as a win-win deal, even though unilateral trade liberalization should be its own reward, according to free trade theory.

The proposal was debated in the December 2005Hong Kong ministerial meeting of the World Trade Organisation. As no agreement could be reached, the negotiation was extended until the following summer, where it was finally put into a state of suspended animation – Mr Kamal Nath, the Indian commerce minister, famously described the negotiation to be 'between intensive care and crematorium'. The rich countries said that the developing countries were not offering sufficient industrial tariff cuts, while the developing countries argued that the rich countries were demanding excessively steep industrial tariff cuts and not offering enough reduction in agricultural tariffs and subsidies. The negotiation is stalled for the moment, but this 'industry-agriculture swap' is basically seen as the way forward by many people, even including some traditional critics of the WTO.

In the short run, greater opening of agricultural markets in the rich countries may benefit developing countries – but only a few of them.Many developing countries are in fact net agricultural importers and thus unlikely to benefit from it. They may even get hurt, if they happen to be importers of those agricultural products that are heavily subsidized by the rich countries. Eliminating those subsidies would increase these developing countries' import bills.

Overall, the main beneficiaries of the opening up of agricultural markets in the rich world will be those rich countries with strong agriculture – the US, Canada, Australia and New Zealand.[16] Developed countries do not protect many agricultural products exported by poor countries (e.g., coffee, tea, cocoa) for the simple reason that they do not have any domestic producer to protect. So, where protection and subsidies are going to come down is mainly in 'temperate zone' agricultural products like wheat, beef and dairy. Only two developing countries, Brazil and Argentina, are major exporters of these products. Moreover, some (although obviously not all) of the prospective 'losers' from

agricultural trade liberalization within rich countries will be the least well-off people by their national standards (e.g., hard-pressed farmers in Norway, Japan or Switzerland), while some of the beneficiaries in developing countries are already rich even by international standards (e.g., agricultural capitalists in Brazil or Argentina). In this sense, the popular image that agricultural liberalization in rich countries is helping poor peasant farmers in developing countries is misleading.[*]

More importantly, those who see agricultural liberalization in the rich countries as an important way to help poor countries develop often fail to pay enough attention to the fact that it does not come for free. In return, the poor countries will have to make concessions. The problem is that these concessions – reducing industrial tariffs, dismantling foreign investment controls and abandoning 'permissive' intellectual property rights – will make their economic development more difficult in the long run. These are policy tools that are crucial for economic development, as I document throughout this book.

Given this, the current debate surrounding the liberalization of agriculture in rich countries is getting its priorities wrong. It may be valuable for some developing countries to get access to agricultural markets in developed economies.[*] But it is far more important that we allow developing countries to use protection, subsidies and regulation of foreign investment adequately in order to develop their own economies, rather than giving them bigger agricultural markets overseas. Especially if agricultural liberalization by the rich countries can only be 'bought' by the developing countries giving up their use of the tools of infant industry promotion, the price is not worth paying. Developing countries should not be forced to sell their future for small immediate gains.

More trade, fewer ideologies

It is hard to believe today, but North Korea used to be richer than South Korea. It was the part of Korea that Japan had developed industrially when it ruled the country from 1910 until 1945. The Japanese colonial rulers saw the northern part of Korea as the ideal base from which to launch their imperialist plan to take over China. It is close to China, and has considerable mineral resources, especially coal. Even after the Japanese left, their industrial legacy enabled North Korea to maintain its economic lead over South Korea well into the 1960s.

Today, South Korea is one of the world's industrial powerhouses, while North Korea languishes in poverty.Much of this is thanks to the fact that South Korea aggressively traded with the outside world and actively absorbed foreign technologies while North Korea pursued its doctrine of self-sufficiency. Through trade, South Korea learned about the existence of better technologies and earned the foreign currency that it needed in order to buy them. In its own way, North Korea has managed some technological feats. For example, it has figured out a way to mass-produce Vinalon, a synthetic fibre made out of – of all things – limestone, invented by a Korean scientist in 1939.Despite being the second-ever man-made fibre after Nylon, Vinalon did not catch on elsewhere because it did not make a comfortable fabric, but it has allowed North Koreans to be self-sufficient in clothes. But there is a limit to what a single developing country can invent on its own without continuous importation of advanced technologies. Thus, North Korea is technologically stuck in the past, with 1940s Japanese

and 1950s Soviet technologies, while South Korea is one of the most technologically dynamic economies in the world. Do we need any better proof that trade is good for economic development?

In the end, economic development is about acquiring and mastering advanced technologies. In theory, a country can develop such technologies on its own, but such a strategy of technological self-sufficiency quickly hits the wall, as seen in the North Korean case. This is why all successful cases of economic development have involved serious attempts to get hold of and master advanced foreign technologies (more on this in chapter 6). But in order to be able to import technologies from developed countries, developing nations need foreign currency to pay for them – whether they want to buy directly (e.g., technology licences, technology consultancy services) or indirectly (e.g., better machines). Some of the necessary foreign currency may be provided through gifts from rich countries (foreign aid), but most has to be earned through exports.Without trade, therefore, there will be little technological progress and thus little economic development.

But there is a huge difference between saying that trade is essential for economic development and saying that free trade is best (or, at least, that freer trade is better) for economic development, as the Bad Samaritans do. It is this sleight of hand that free trade economists have so effectively deployed in cowing their opponents – if you are against free trade, they insinuate, you must be against progress.

As South Korea shows, active participation in international trade does not require free trade. Indeed, had South Korea pursued free trade and not promoted infant industries, it would not have become a major trading nation. It would still be exporting raw materials (e.g., tungsten ore, fish, seaweed) or low-technology, low-price products (e.g., textiles, garments, wigs made with human hair) that used to be its main export items in the 1960s. To go back to the imagery of chapter 1, had they followed free trade policy from the 1960s, Koreans might still be fighting over who owns which tuft of hair, so to speak. The secret of its success lay in a judicious mix of protection and open trade, with the areas of protection constantly changing as new infant industries were developed and old infant industries became internationally competitive. In a way, this is not much of a 'secret'. As I have shown in the earlier chapters, this is how almost all of today's rich countries became rich and this is at the root of almost all recent success stories in the developing world. Protection does not guarantee development, but development without it is very difficult.

Therefore, if they are genuinely to help developing countries develop through trade, wealthy countries need to accept asymmetric protectionism, as they used to between the 1950s and the 1970s. They should acknowledge that they need to have much lower protection for themselves than the developing countries have. The global trading system should support the developmental efforts of developing countries by allowing them to use more freely the tools of infant industry promotion – such as tariff protection, subsidies and foreign investment regulation. At the moment, the system allows protection and subsidies much more readily in areas where the developed countries need them. But it should be the other way around – protection and subsidies should be easier to use where the developing countries need them more.

Here, it is particularly important to get our perspective right about agricultural liberalization in the rich countries. Lowering agricultural protection in

those countries may help some developing countries, especially Brazil and Argentina, but not most. Above all, agricultural liberalization in the rich world should not be conditional upon further restrictions on the use of the tools of infant industry promotion by developing nations, as is currently being demanded by the rich countries.

The importance of international trade for economic development cannot be overemphasized. But free trade is *not* the best path to economic development.Trade helps economic development only when the country employs a mixture of protection and open trade, constantly adjusting it according to its changing needs and capabilities. Trade is simply too important for economic development to be left to free trade economists.

* The HOS theory is named after the two Swedish economists, Eli Heckscher and Bertil Ohlin, who pioneered it in the early 20th century, and Paul Saumelson, the American economist who perfected it in the mid-20th century. In this version of free trade theory, for each product there is only one 'best practice' (i.e., most efficient) technology, which all countries will use if they are producing it. If each product has one best production technology for its production, a country's comparative advantage can *not* be determined by its technologies, as in Ricardo's theory. It is determined by how suitable the technology used for each product is for the country. In the HOS theory, the suitability of a particular technology for a country depends on how intensively it uses the factor of production (i.e., labour or capital) with which the country is relatively abundantly endowed.

† So, 'comparative' in the term 'comparative advantage' is not about comparison between countries but about comparison between products. It is because people mix

these two up that they sometimes believe that poor countries do not have comparative advantage in anything – which is a logical impossibility.

* The other main beneficiaries of agricultural liberalization in rich countries, that is, their consumers, do not gain very much. As a proportion of income, their spending on agricultural products is already pretty low (around 13% for food and 4% for alcohol and tobacco, of which only a fraction is the cost of the agricultural produce itself). Moreover, the trade in many agricultural products they buy is already liberalized (e.g., coffee, tea, cocoa).

* In the earlier stages of development, most people live on agriculture, so developing agriculture is crucial in reducing poverty. Higher agricultural productivity also creates a pool of healthy and productive workers that can be used later for industrial development. In the early stages of development, agricultural products are also likely to account for a high share of exports, as the country may have little else to sell. Given the importance of export earnings for economic development that I discussed earlier, agricultural exports should be increased as much as possible (although the scope may not be large). And, for this, greater opening of agricultural markets in the rich countries is helpful. But increased agricultural productivity and agricultural exports often require state intervention along the line of 'infant industry promotion'. Agricultural producers, especially the smaller ones, need government investment and support in infrastructure (especially irrigation for production and roads for exports), international marketing and R&D.

CHAPTER 4
The Finn and the elephant

Should we regulate foreign investment?

The Finns like to tell a joke about themselves.What would a German, a Frenchman, an American and a Finn do if they were each asked to write a book on the elephant? The German, with his characteristic thoroughness, would write a thick two-volume, fully annotated study entitled, *Everything That There is to Know About the Elephant*. The Frenchman, with his penchant for philosophical musings and existential anguish, would write a book entitled *The Life and Philosophy of the Elephant*. The American, with his famous nose for good business opportunities, would naturally write a book entitled, *How to Make Money with an Elephant*. The Finn would write a book entitled *What Does the Elephant Think of the Finns?*

The Finns are laughing at their excessive self-consciousness. Their preoccupation with their own identity is understandable. They speak a language that is more related to Korean and Japanese than to the language of their Swedish or Russian neighbours. Finland was a Swedish colony for around six hundred years and a Russian colony for about a hundred. As a Korean, whose country has been pushed around for thousands of years by every neighbour in sight – the Chinese, the Huns, the Mongolians, the Manchurians, the Japanese, the Americans, the Russians, you name it – I know the feeling.

So, it was unsurprising that, after gaining independence from Russia in 1918, Finland tried its best to keep foreigners out. The country introduced a series of laws in the 1930s that officially classified all the enterprises with more than 20% foreign ownership as – hold your breath – 'dangerous'. The Finns may not be the subtlest people in the world, but this is heavy stuff even for them. Finland got, as it had wanted, very little foreign investment.[1] When Monty Python sang in 1980, 'Finland, Finland, Finland . . . You are so sadly neglected, and often ignored' ('The Finland Song'), they did not perhaps guess that the Finns *had sought* to be neglected and ignored.

The Finnish law was eventually relaxed in 1987, and the foreign ownership ceiling was raised to 40%, but all foreign investments still had to be approved by the Ministry of Trade and Industry. General liberalization of foreign investment did not come until 1993, as part of the preparations for the country's accession to the EU in 1995.

According to the neo-liberal orthodoxy, this sort of extreme anti-foreign strategy, especially if sustained for over half a century, should have severely damaged Finland's economic prospects. However, since the mid-1990s, Finland has been touted as the paragon of successful global integration. In particular, Nokia, its mobile phone company, has been, figuratively speaking, inducted into the Globalization Hall of Fame. A country that did not want to be a part of the global economy has suddenly become an icon of globalization. How was this possible? We shall answer that later, but first let us examine the arguments for and against foreign investment.

Is foreign capital essential?

Many developing countries find it difficult to generate enough savings to satisfy their own investment

demands. Given this, it seems uncontroversial that any additional money they can get from other countries that have surplus savings should be good. Developing countries should open their capital markets, it is argued by the Bad Samaritans, so that such money can flow in freely.

The benefit of having free international movement of capital, neo-liberal economists argue, does not stop at plugging such a 'savings gap'. It improves economic efficiency by allowing capital to flow into projects with the highest possible returns on a global scale. Free cross-border capital flows are also seen as spreading 'best practice' in government policy and corporate governance. Foreign investors would simply pull out, the reasoning goes, if companies and countries were not well run.[2] Some even, controversially, argue that these 'collateral benefits' are even more important than the direct benefits that come from the more efficient allocation of capital.[3]

Foreign capital flows into developing countries consist of three main elements – grants, debts and investments. Grants are money given away (but often with strings attached) by another country and are called foreign aid or official development assistance (ODA). Debts consist of bank loans and bonds (government bonds and corporate bonds).[4] Investments are made up of 'portfolio equity investment', which is equity (share) ownership seeking financial returns rather than managerial influence, and foreign direct investment (FDI), which involves the purchase of equity with a view to influence the management of the firm on a regular basis.[5]

There is an increasingly popular view among neo-liberal economists that foreign aid does not work, although others argue that the 'right' kind of aid (that is, aid that is not primarily motivated by geo-politics) works.[6] Debts and portfolio equity investment have also come under attack for their volatility.[7] Bank loans are notoriously volatile. For example, in 1998, total net bank loans to developing countries were $50 billion; following a series of financial crises that engulfed the developing world (Asia in 1997, Russia and Brazil in 1998, Argentina in 2002), they turned *negative* for the next four years (-$6.5 billion per year on average); by 2005, however, they were 30% higher than in 1998 ($67 billion). Although not as volatile as bank loans, capital inflows through bonds fluctuate a lot.[8] Portfolio equity investment is even more volatile than bonds, although not as volatile as bank loans.[9]

These flows are not just volatile, they tend to come in and go out exactly at the wrong time.When economic prospects in a developing country are *considered* good, too much foreign financial capital may enter. This can temporarily raise asset prices (e.g., prices of stocks, real estate prices) beyond their real value, creating asset bubbles.When things get bad, often because of the bursting of the very same asset bubble, foreign capital tends to leave all at the same time, making the economic downturn even worse. Such 'herd behaviour' was most vividly demonstrated in the 1997 Asian crises, when foreign capital flowed out on a massive scale, despite the good long-term prospects of the economies concerned (Korea, Hong Kong, Malaysia, Thailand and Indonesia).[10]

Of course, this kind of behaviour – known as 'pro-cyclical' behaviour – also exists among domestic investors. Indeed, when things go bad, these investors, using their insider information, often leave the country *before* the foreigners do. But the impact of herd behaviour by foreign investors is much greater for the simple reason that developing country financial markets are tiny relative to the amounts of money

sloshing around the international financial system. The Indian stock market, the largest stock market in the developing world, is less than one-thirtieth the size of the US stock market.[11] The Nigerian stock market, the second largest in Sub-Saharan Africa, is worth less than one five-thousandth of the US stock market. Ghana's stock market is worth only 0.006% of the US market.[12] What is a mere drop in the ocean of rich country assets will be a flood that can sweep away financial markets in developing countries.

Given this, it is no coincidence that developing countries have experienced more frequent financial crises since many of them opened their capital markets at the urge of the Bad Samaritans in the 1980s and the 1990s. According to a study by two leading economic historians, between 1945 and 1971, when global finance was not liberalized, developing countries suffered no banking crises, 16 currency crises and one 'twin crisis' (simultaneous currency and banking crises). Between 1973 and 1997, however, there were 17 banking crises, 57 currency crises and 21 twin crises in the developing world.[13] This is not even counting some of the biggest financial crises that occurred after 1998 (Brazil, Russia and Argentina being the most prominent cases).

The volatility and the pro-cyclicality of international financial flows are what make even some globalization enthusiasts, such as Professor Jagdish Bhagwati, warn against what he calls 'the perils of gung-ho international financial capitalism'.[14] Even the IMF, which used to push strongly for capital market opening during the 1980s and especially the 1990s, has recently changed its stance on this matter, becoming a lot more muted in its support of capital market opening in developing countries.[15] Now it accepts that 'premature opening of the capital account . . . can hurt a country by making the structure of the inflows unfavourable and by making the country vulnerable to sudden stops or reversals of flows.'[16]

The Mother Teresa of foreign capital?

The behaviour of international *financial* flows (debt and portfolio equity investment) is in stark contrast with that of foreign direct investment. Net FDI flows into developing countries were $169 billion in 1997.[17] Despite the financial turmoil in the developing world, it was still $172 billion per year on average between 1998 and 2002.[18] In addition to its stability, foreign direct investment is thought to bring in not just money but a lot of other things that help economic development. Sir Leon Brittan, a former British commissioner of the European Union, sums it up: foreign direct investment is 'a source of extra capital, a contribution to a healthy external balance, a basis for increased productivity, additional employment, effective competition, rational production, technology transfer, and a source of managerial knowhow.'[19]

The case for welcoming foreign direct investment, then, seems overwhelming. FDI is stable, unlike other forms of foreign capital inflows. Moreover, it brings not just money but also enhances the host country's productive capabilities by bringing in more advanced organization, skills and technology. No wonder that foreign direct investment is fêted as if it were 'the Mother Teresa of foreign capital', as Gabriel Palma, the distinguished Chilean economist who is my former teacher and now a colleague at Cambridge, once ironically observed. But foreign direct investment has its limitations and problems.

First, foreign direct investment flows may have been very stable during the financial turmoil in developing countries in the late 1990s and the early 2000s, but it

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has not always been the case for all countries.[20] When a country has an open capital market, FDI can be made 'liquid' and shipped out rather quickly. As even an IMF publication points out, the foreign subsidiary can use its assets to borrow from domestic banks, change the money into foreign currency and send the money out; or the parent company may recall the intra-company loan it has lent to the subsidiary (this counts as FDI).[21] In the extreme case, most foreign direct investment that came in can go out again through such channels, adding little to the host country's foreign exchange reserve position.[22]

Not only is FDI not necessarily a stable source of foreign currency, it may have negative impacts on the foreign exchange position of the host country. FDI may bring in foreign currency, but it can also generate additional demands for it (e.g., importing inputs, contracting foreign loans). Of course, it can (but may not) also generate additional foreign currency through exporting, but whether it will earn more foreign exchange than it uses is not a foregone conclusion. This is why many countries have imposed controls on the foreign exchange earnings and spending by the foreign companies making the investment (e.g., how much they should export, how much inputs they have to buy locally).[23]

Another drawback with foreign direct investment is that it creates the opportunity for 'transfer pricing' by transnational corporations (TNCs) with operations in more than one country. This refers to the practice where the subsidiaries of a TNC are overcharging or undercharging each other so that profits are highest in those subsidiaries operating in countries with the lowest corporate tax rates. And when I say overcharging or undercharging, I really mean it. A Christian Aid report documents cases of underpriced exports like TV

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antennas from China at $0.40 apiece, rocket launchers from Bolivia at $40 and US bulldozers at $528, and overpriced imports such as German hacksaw blades at $5, 485 each, Japanese tweezers at $4, 896, and French wrenches at $1, 089.[24] This is a classic problem with TNCs, but today the problem has become more severe because of the proliferation of tax havens that have no or minimal corporate income taxes.Companies can vastly reduce their tax obligations by shifting most of their profits to a paper company registered in a tax haven.

It may be argued that the host country should not complain about transfer pricing, because, without the foreign direct investment in question, the taxable income would not have been generated in the first place. But this is a disingenuous argument. All firms need to use productive resources provided by government with taxpayers' money (e.g., roads, the telecommunications network, workers who have received publicly funded education and training). So, if the TNC subsidiary is not paying its 'fair share' of tax, it is effectively free-riding on the host country.

Even for the technologies, skills and management know-how that foreign direct investment is supposed to bring with it, the evidence is ambiguous: '[d]espite the theoretical presumption that, of the different types of [capital] inflows, FDI has the strongest benefits, it has not proven easy to document these benefits' – and that's what an IMF publication is saying.[25] Why is this? It is because different types of FDI have different productive impacts.

When we think of foreign direct investment, most of us think about Intel building a new microchip factory in Costa Rica or Volkswagen laying down a new assembly line in China – this is known as 'greenfield' investment. But a lot of foreign direct investment is made by

foreigners buying into an existing local company – or 'brownfield' investment.[26] Brownfield investment has accounted for over half of total world FDI since the 1990s, although the share is lower for developing countries, for the obvious reason that they have relatively fewer firms that foreigners want to take over.At its height in 2001, it accounted for as much as 80% of total world FDI.[27]

Brownfield investment does not add any new production facilities – when General Motors bought up the Korean car maker Daewoo in the wake of the 1997 financial crisis, it just took over the existing factories and produced the same cars, designed by Koreans, under different names. However, brownfield investment can still lead to an increase in productive capabilities. This is because it can bring with it new management techniques or higher quality engineers. The trouble is that there is no guarantee that this will happen.

In some cases, brownfield FDI is made with an explicit intention of not doing much to improve the productive capabilities of the company bought – a foreign direct investor might buy a company that he thinks is undervalued by the market, especially in times of financial crisis, and run it as it used to be until he finds a suitable buyer.[28] Sometimes the foreign direct investor may even actively *destroy* the existing productive capabilities of the company bought by engaging in 'asset stripping'. For example, when the Spanish airline Iberia bought some Latin American airlines in the 1990s, it swapped its own old planes for the new ones owned by the Latin American airlines, eventually driving some of the latter into bankruptcy due to a poor service record and high maintenance costs.

Of course, the value of foreign direct investment to the host economy is not confined to what it does to the enterprise in which the investment has been made. The enterprise concerned hires local workers (who may learn new skills), buys inputs from local producers (who may pick up new technologies in the process) and has some 'demonstration effects' on domestic firms (by showing them new management techniques or providing knowledge about overseas markets). These effects, known as 'spill-over effects', are real additions to a nation's long-run productive capabilities and not to be scoffed at.

Unfortunately, the spill-over effects may not happen. In the extreme case, a TNC can set up an 'enclave' facility, where all inputs are imported and all that the locals do is to engage in simple assembly, where they do not even pick up new skills.Moreover, even when they occur, spillover effects tend to be relatively insignificant in magnitude.[29] This is why governments have tried to magnify them by imposing performance requirements – regarding, for example, technology transfer, local contents or exports.[30]

A critical but often ignored impact of FDI is that on the (current and future) domestic competitors. An entry by a TNC through FDI can destroy existing national firms that could have 'grown up' into successful operations without this premature exposure to competition, or it can pre-empt the emergence of domestic competitors. In such cases, short-run productive capabilities are enhanced, as the TNC subsidiary replacing the (current and future) national firms is usually more productive than the latter. But the level of productive capability that the country can attain *in the long run* becomes lower as a result.

This is because TNCs do not, as a rule, transfer the most valuable activities outside their home country, as I will discuss in greater detail later. As a result, there will

be a definite ceiling on the level of sophistication that a TNC subsidiary can reach in the long run. To go back to the Toyota example in chapter 1, had Japan liberalized FDI in its automobile industry in the 1960s, Toyota definitely wouldn't be producing the Lexus today – it would have been wiped out or, more likely, have become a valued subsidiary of an American carmaker.

Given this, a developing country may reasonably decide to forego short-term benefits from FDI in order to increase the chance for its domestic firms to engage in higher-level activities in the long run, by banning FDI in certain sectors or regulating it.[31] This is exactly the same logic as that of infant industry protection that I discussed in the earlier chapters – a country gives up the short-run benefits of free trade in order to create higher productive capabilities in the long run. And it is why, historically, most economic success stories have resorted to regulation of FDI, often in a draconian manner, as I shall now show.

'More dangerous than military power'

'It will be a happy day for us when not a single good American security is owned abroad and when the United States shall cease to be an exploiting ground for European bankers and money lenders.' Thus wrote the US *Bankers' Magazine* in 1884.[32]

The reader may find it hard to believe that a *bankers'* magazine published in *America* could be so hostile to foreign investors. But this was in fact true to type at the time. The US had a terrible record in its dealings with foreign investors.[33]

In 1832, Andrew Jackson, today a folk hero to American free-marketeers, refused to renew the licence for the quasi-central bank, the second Bank of the USA – the successor to Hamilton's Bank of the USA (see chapter 2).[34] This was done on the grounds that the foreign ownership share of the bank was too high – 30% (the pre-EU Finns would have heartily approved!). Declaring his decision, Jackson said: 'should the stock of the bank principally pass into the hands of the subjects of a foreign country, and we should unfortunately become involved in a war with that country, what would be our condition? . . .Controlling our currency, receiving our public moneys, and holding thousands of our citizens in dependence, it would be far more formidable and dangerous than the naval and military power of the enemy. If we must have a bank . . . it should be *purely American*.'[35] If the president of a developing country said something like this today, he would be branded a xenophobic dinosaur and blackballed in the international community.

From the earliest days of its economic development right up to the First World War, the US was the world's largest importer of foreign capital.[36] Given this, there was, naturally, considerable concern over 'absentee management' by foreign investors[37]; 'We have no horror of FOREIGN CAPITAL – if subjected to *American management* [italics and capitals original], ' declared *Niles' Weekly Register*, a nationalist magazine in the Hamiltonian tradition, in 1835.[38]

Reflecting such sentiment, the US federal government strongly regulated foreign investment. Non-resident shareholders could not vote and only American citizens could become directors in a national (as opposed to state-level) bank. This meant that 'foreign individuals and foreign financial institutions could buy shares in U.S. national banks *if* they were prepared to have American citizens as their representatives on the board of directors', thus discouraging foreign investment in the banking sector.[39] A navigation monopoly for US ships in coastal

shipping was imposed in 1817 by Congress and continued until the First World War.[40] There were also strict regulations on foreign investment in natural resource industries. Many state governments barred or restricted investment by non-resident foreigners in land. The 1887 federal Alien Property Act prohibited the ownership of land by aliens – or by companies more than 20% owned by aliens – in the 'territories' (as opposed to the fully fledged states), where land speculation was particularly rampant.[41] Federal mining laws restricted mining rights to US citizens and companies incorporated in the US. In 1878, a timber law was enacted, permitting only US residents to log on public land.

Some state (as opposed to federal) laws were even more hostile to foreign investment. A number of states taxed foreign companies more heavily than the American ones. There was a notorious Indiana law of 1887 that withdrew court protection from foreign firms altogether.[42] In the late 19th century, the New York state government took a particularly hostile attitude towards FDI in the financial sector, an area where it was rapidly developing a world-class position (a clear case of infant industry protection).[43] It instituted a law in the 1880s that banned foreign banks from engaging in 'banking business' (such as taking deposits and discounting notes or bills). The 1914 banking law banned the establishment of foreign bank branches. For example, the London City and Midland Bank (then the world's third largest bank, measured by deposits) could not open a New York branch, even though it had 867 branches worldwide and 45 correspondent banks in the US alone.[44]

Despite its extensive, and often strict, controls on foreign investment, the US was the largest recipient of foreign investment throughout the 19th century and the early 20th century – in the same way strict regulation of TNCs in China has not prevented a large amount of FDI from pouring into that country in recent decades. This flies in the face of the belief by the Bad Samaritans that foreign investment regulation is bound to reduce investment flows, or, conversely, that the liberalization of foreign investment regulation will increase foreign investment flows.Moreover, despite – or, I would argue, partly because of – its strict regulation of foreign investment (as well as having in place manufacturing tariffs that were the highest in the world), the US was the world's fastest-growing economy throughout the 19th century and up until the 1920s. This undermines the standard argument that foreign investment regulation harms the growth prospects of an economy.

Even more draconian than the US in regulating foreign investment was Japan.[45] Especially before 1963, foreign ownership was limited to 49%, while in many 'vital industries' FDI was banned altogether. Foreign investment was steadily liberalized, but only in industries where the domestic firms were ready for it. As a result, of all countries outside the communist bloc, Japan has received the lowest level of FDI as a proportion of its total national investment.[46] Given this history, the Japanese government saying that '[p]lacing constraints on [foreign direct] investment would not seem to be an appropriate decision even from the perspective of development policy' in a recent submission to the WTO is a classic example of selective historical amnesia, double standards and 'kicking away the ladder'[47]

Korea and Taiwan are often seen as pioneers of pro-FDI policy, thanks to their early successes with export-processing zones (EPZs), where the investing foreign firms were little regulated. But, outside these zones, they actually imposed many restrictive policies on

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foreign investors. These restrictions allowed them to accumulate technological capabilities more rapidly, which, in turn, reduced the need for the 'anything goes' approach found in their EPZs in subsequent periods. They restricted the areas where foreign companies could enter and put ceilings on their ownership shares. They also screened the technologies brought in by TNCs and imposed export requirements. Local content requirements were quite strictly imposed, although they were less stringently applied to exported products (so that lower quality domestic inputs would not hurt export competitiveness too much). As a result, Korea was one of the least FDI-dependent countries in the world until the late 1990s, when the country adopted neo-liberal policies.[48] Taiwan, where the policies were slightly milder than in Korea, was somewhat more dependent on foreign investment, but its dependence was still well below the developing country average.[49]

The bigger European countries – the UK, France and Germany – did not go as far as Japan, the USA or Finland in regulating foreign investment. Before the Second World War, they didn't need to – they were mostly making, rather than receiving, foreign investments. But, after the Second World War, when they started receiving large amounts of American, and then Japanese, investment, they also restricted FDI flows and imposed performance requirements. Until the 1970s, this was done mainly through foreign exchange controls. After these controls were abolished, informal performance requirements were used. Even the ostensibly foreign-investor-friendly UK government used a variety of 'undertakings' and 'voluntary restrictions' regarding local sourcing of components, production volumes and exporting.[50] When Nissan established a UK plant in 1981, it was forced to procure 60% of value added locally, with a time scale over which this would rise to 80%. It is reported that the British government also 'put pressure on [Ford and GM] to achieve a better balance of trade.'[51]

Even cases like Singapore and Ireland, countries that have succeeded by extensively relying on FDI, are *not* proof that host country governments should let TNCs do whatever they want. While welcoming foreign companies, their governments used selective policies to attract foreign investment into areas that they considered strategic for the future development of their economies. Unlike Hong Kong, which *did* have a liberal FDI policy, Singapore has always had a very targeted approach. Ireland started genuinely prospering only when it shifted from an indiscriminate approach to FDI ('the more, the merrier') to a focused strategy that sought to attract foreign investment in sectors like electronics, pharmaceuticals, software quite and financial services. It also used performance requirements quite widely.[52]

To sum up, history is on the side of the regulators. Most of today's rich countries regulated foreign investment when they were on the receiving end. Sometimes the regulation was draconian – Finland, Japan, Korea and the USA (in certain sectors) are the best examples. There were countries that succeeded by actively courting FDI, such as Singapore and Ireland, but even they did not adopt the *laissez-faire* approach towards TNCs that is recommended to the developing countries today by the Bad Samaritans.

Borderless world?

Economic theory, history and contemporary experiences all tell us that, in order truly to benefit from foreign direct investment, the government needs to regulate it well. Despite all this, the Bad Samaritans

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have been trying their best to outlaw practically all regulation of foreign direct investment over the last decade or so. Through the World Trade Organisation, they have introduced the TRIMS (Trade-related Investment Measures) Agreement, which bans things like local content requirements, export requirements or foreign exchange balancing requirements. They have been pushing for further liberalization through the current GATS (General Agreement on Trade in Services) negotiations and a proposed investment agreement at the World Trade Organisation. Bilateral and regional free trade agreements (FTAs) and bilateral investment treaties (BITs) between rich and poor countries also restrict the ability of developing countries to regulate FDI.[53]

Forget history, say the Bad Samaritans in defending such actions. Even if it did have some merits in the past, they argue, regulation of foreign investment has become unnecessary *and* futile, thanks to globalization, which has created a new 'borderless world'. They argue that the 'death of distance' due to developments in communications and transportation technologies has made firms more and more mobile and thus stateless – they are not attached to their home countries any more. If firms do not have nationality any more, it is argued, there are no grounds for discriminating against foreign firms. Moreover, any attempt to regulate foreign firms is futile, as, being 'footloose', they would move to another country where there is no such regulation.

There is certainly an element of truth in this argument. But the case is vastly exaggerated. There are, today, firms like Nestlé that produces less than 5% of its output at home (Switzerland), but they are very much the exceptions. Most large internationalized firms produce less than one-third of their output abroad, while the ratio in the case of Japanese companies is well below 10%.[54] There has been some relocation of 'core' activities (such as research & development) overseas, but it is usually to other developed countries, and with a heavy 'regional' bias (the regions here meaning North America, Europe and Japan, which is a region unto itself).[55]

In most companies, the top decision-makers are still mostly home country nationals. Once again, there are cases like Carlos Ghosn, the Lebanese-Brazilian who runs a French (Renault) and Japanese (Nissan) company. But he is also very much an exception. The most telling example is the merger of Daimler-Benz, the German car maker, and Chrysler, the US car maker, in 1998. This was really a takeover of Chrysler by Benz. But, at the time of the merger, it was depicted as a marriage of two equals. The new company, Daimler-Chrysler, even had equal numbers of Germans and Americans on the management board. But that was only for the first few years. Soon, the Germans vastly outnumbered the Americans – usually 10 or 12 to one or two, depending on the year. When they are taken over, even American firms end up run by foreigners (but then that is what take-over means).

Therefore, the nationality of the firm still matters very much.Who owns the firm determines how far its different subsidiaries will be allowed to move into higher-level activities. It would be very naïve, especially on the part of developing countries, to design economic policies on the assumption that capital does not have national roots anymore.

But then how about the argument that, whether necessary or not, it is no longer possible in practice to regulate foreign investment? Now that TNCs have become more or less 'footloose', it is argued, they can punish countries that regulate foreign investment by 'voting with their feet'.

One immediate question one can ask is: if firms have become so mobile as to make national regulation powerless, why are the Bad Samaritan rich countries so keen on making developing countries sign up to all those international agreements that restrict their ability to regulate foreign investment? Following the market logic so loved by the neo-liberal orthodoxy, why not just leave countries to choose whatever approach they want and then let foreign investors punish or reward them by choosing to invest only in those countries friendly towards foreign investors? The very fact that rich countries want to impose all these restrictions on developing countries by means of international agreements reveals that regulation of FDI is not yet futile after all, contrary to what the Bad Samaritans say.

In any case, not all TNCs are equally mobile. True, there are industries – such as garments, shoes and stuffed toys – for which there are numerous potential investment sites because production equipment is easy to move and, the skills required being low, workers can be easily trained. However, in many other industries, firms cannot move that easily for various reasons – the existence of immobile inputs (e.g., mineral resources, a local labour force with particular skills), the attractiveness of the domestic market (China is a good example), or the supplier network that they have built up over the years (e.g., subcontracting networks for Japanese car makers in Thailand or Malaysia).

Last but not least, it is simply wrong to think that TNCs will necessarily avoid countries that regulate FDI. Contrary to what the orthodoxy suggests, regulation is *not* very important in determining the level of inflow of foreign investment. If that were the case, countries like China would not be getting much foreign investment. But the country is getting around 10% of world FDI because it offers a large and fast-growing market, a good labour force and good infrastructure (roads, ports). The same argument can be applied to the 19th-century US.

Surveys reveal that corporations are most interested in the market potential of the host country (market size and growth), and then in things like the quality of the labour force and infrastructure, with regulation being only a matter of minor interest. Even the World Bank, a well-known supporter of FDI liberalization, once admitted that '[t]he specific incentives and regulations governing direct investment have less effect on how much investment a country receives than has its general economic and political climate, and its financial and exchange rate policies'.[56]

As in the case of their argument about the relationship between international trade and economic development, the Bad Samaritans have got the casuality all wrong. They think that, if you liberalize foreign investment regulation, more investment will flow in and help economic growth. But foreign investment follows, rather than causes, economic growth. The brutal truth is that, however liberal the regulatory regime, foreign firms won't come into a country unless its economy offers an attractive market and high-quality productive resources (labour, infrastructure). This is why so many developing countries have failed to attract significant amounts of FDI, despite giving foreign firms maximum degrees of freedom. Countries have to get growth going *before* TNCs get interested in them. If you are organizing a party, it is not enough to tell people that they can come and do whatever they want. People go to parties where they know there are already interesting things happening. They don't usually come and make things interesting for you, whatever freedom you give them.

'The only thing worse than being exploited by capital . . .'

Like Joan Robinson, a former Cambridge economics professor and arguably the most famous female economist in history, I believe that the only thing that is worse than being exploited by capital is not being exploited by capital. Foreign investment, especially foreign direct investment, can be a very useful tool for economic development. But *how* useful it is depends on the kinds of investment made and how the host country government regulates it.

Foreign financial investment brings more danger than benefits, as even the neo-liberals acknowledge these days. While foreign direct investment is no Mother Teresa, it often does bring benefits to the host country *in the short run*. But it is the long run that counts when it comes to economic development. Accepting FDI unconditionally may actually make economic development in the long run more difficult. Despite the hyperbole about a 'borderless world', TNCs remain national firms with international operations and, therefore, are unlikely to let their subsidiaries engage in higher-level activities; at the same time their presence can prevent the emergence of national firms that might start them in the long run. This situation is likely to damage the long-run development potential of the host country. Moreover, the long-run benefits of FDI depend partly on the magnitude and the quality of the spill-over effects that TNCs create, whose maximization requires appropriate policy intervention.Unfortunately, many key tools of such intervention have already been outlawed by the Bad Samaritans (e.g., local content requirements).

Therefore, foreign direct investment can be a Faustian bargain. In the short run, it may bring benefits, but, in the long run, it may actually be bad for economic development. Once this is understood, Finland's success is unsurprising. The country's strategy was based on the recognition that, if foreign investment is liberalized too early (Finland was one of the poorest European economies in the early-20th century), there will be no space for domestic firms to develop independent technological and managerial capabilities. It took Nokia 17 years to earn any profit from its electronics subsidiary, which is now the biggest mobile phone company in the world.[57] If Finland had liberalized foreign investment from early on, Nokia would not be what it is today. Most probably, foreign financial investors who bought into Nokia would have demanded the parent company stop cross-subsidizing the no-hope electronics subsidiary, thus killing off the business. At best, some TNC would have bought up the electronics division and made it into its own subsidiary doing second-division work.

The flip side of this argument is that regulation of foreign direct investment may paradoxically benefit foreign companies in the long run. If a country keeps foreign companies out or heavily regulates their activities, it will not be good for those companies in the short run. However, if a judicious regulation of foreign direct investment allows a country to accumulate productive capabilities more rapidly and at a higher level than possible without it, it will benefit foreign investors in the long run by offering them an investment location that is more prosperous and possesses better productive inputs (e.g., skilled workers, good infrastructure). Finland and Korea are the best examples of this. Partly thanks to their clever foreign investment regulation, these countries have become richer, better educated and technologically far more dynamic and thus have become more attractive

investment sites than would have been possible without those regulations.

Foreign direct investment may help economic development, but only when introduced as part of a long-term-oriented development strategy. Policies should be designed so that foreign direct investment does not kill off domestic producers, which may hold out great potential in the long run, while also ensuring that the advanced technologies and managerial skills foreign corporations possess are transferred to domestic business to the maximum possible extent. Like Singapore and Ireland, some countries can succeed, and have succeeded, through actively courting foreign capital, especially FDI. But more countries will succeed, and have succeeded, when they more actively regulate foreign investment, including FDI. The attempt by the Bad Samaritans to make such regulation by developing countries impossible is likely to hinder, rather than help, their economic development.