Thing 7

Free-market policies rarely make poor countries rich

What they tell you

After their independence from colonial rule, developing countries tried to develop their economies through state intervention, sometimes even explicitly adopting socialism. They tried to develop industries such as steel and automobiles, which were beyond their capabilities, artificially by using measures such as trade protectionism, a ban on foreign direct investment, industrial subsidies, and even state ownership of banks and industrial enterprises. At an emotional level this was understandable, given that their former colonial masters were all capitalist countries pursuing free-market policies. However, this strategy produced at best stagnation and at worst disaster. Growth was anaemic (if not negative) and the protected industries failed to 'grow up'. Thankfully, most of these countries have come to their senses since the 1980s and come to adopt free-market policies. When you think about it, this was the right thing to do from the beginning. All of today's rich countries, with the exception of Japan (and possibly Korea, although there is debate on that), have become rich through free-market policies, especially through free trade with the rest of the world. And developing countries that have more fully embraced such policies have done better in the recent period.

What they don't tell you

Contrary to what is commonly believed, the performance of developing countries in the period of state-led development was superior to what they have achieved during the subsequent period of market-oriented reform. There were some spectacular failures of state intervention, but most of these countries grew much faster, with more equitable income distribution and far fewer financial crises, during the 'bad old days' than they have done in the period of market-oriented reforms. Moreover, it is also *not* true that almost all rich countries have become rich through free-market policies. The truth is more or less the opposite. With only a few exceptions, all of today's rich countries, including Britain and the US – the supposed homes of free trade and free market – have become rich through the combinations of protectionism, subsidies and other policies that today they advise the developing countries not to adopt. Free-market policies have made few countries rich so far and will make few rich in the future.

Two basket cases

Here are the profiles of two developing countries. You are an economic analyst trying to assess their development prospects. What would you say?

Country A: Until a decade ago, the country was highly protectionist, with an average industrial tariff rate well above 30 per cent. Despite the recent tariff reduction, important visible and invisible trade restrictions remain. The country has heavy restrictions on cross-border flows of capital, a state-owned and highly regulated banking sector, and numerous restrictions on foreign ownership of financial assets. Foreign firms producing in the country complain that they are discriminated against through differential taxes and regulations by local governments. The country has no elections and is riddled with corruption. It has opaque and complicated property rights. In particular, its protection of intellectual property rights is weak, making it the pirate capital of the world. The country has a large number of state-owned enterprises, many of which make large losses but are propped up by subsidies and government-granted monopoly rights.

Country B: The country's trade policy has literally been the most protectionist in the world for the last few decades, with an average industrial tariff rate at 40–55 per cent. The majority of the population cannot vote, and vote-buying and electoral fraud are widespread. Corruption is rampant, with political parties selling government jobs to their financial backers. The country has never recruited a single civil servant through an open, competitive process. Its public finances are precarious, with records of government loan defaults that worry foreign investors. Despite this, it discriminates heavily against foreign investors. Especially in the banking sector, foreigners are prohibited from becoming directors while foreign shareholders cannot even exercise their voting rights unless they are resident in the country. It does not have a competition law, permitting cartels and other forms of monopoly to grow unchecked. Its protection of intellectual property rights is patchy, particularly marred by its refusal to protect foreigners' copyrights.

Both these countries are up to their necks in things that are supposed to hamper economic development – heavy protectionism, discrimination against foreign investors, weak protection of property rights, monopolies, lack of democracy, corruption, lack of meritocracy, and so on. You would think that they are both headed for developmental disasters. But think again.

Country A is China today – some readers may have guessed that. However, few readers would have guessed that *Country B* is the USA – that is, around 1880, when it was somewhat poorer than today's China.

Despite all the supposedly anti-developmental policies and institutions, China has been one of the world's most dynamic and successful economies over the last three decades, while the USA in the 1880s was one of the fastest-growing – and rapidly becoming one of the richest – countries in the world. So the economic superstars of the late nineteenth century (USA) and of today (China) have both followed policy recipes that go almost totally against today's neo-liberal free-market orthodoxy.

How is this possible? Hasn't the free-market doctrine been distilled out of two centuries of successful development experiences by today's two dozen rich countries? In order to answer these questions, we need to go back in history.

Dead presidents don't talk

Some Americans call their dollar bills 'dead presidents', or 'dead prez'. Not quite accurately. They are all dead all right, but not all the politicians whose portraits adorn the dollar bills are former presidents of the US.

Benjamin Franklin – who features on the best-known paper money in human history, the $100 bill – never was president. However, he could well have been. He was the oldest of the Founding Fathers and arguably the most revered politician of the new-born country. Although he was too old and George Washington's political stature too great for him to run for the first presidency in 1789, Franklin was the only person who could possibly have challenged

Washington for the job.

The real surprise in the pantheon of presidents on the greenback is Alexander Hamilton, who features on the $10 bill. Like Franklin, Hamilton was never a president of the US. But unlike Franklin, whose life story has become American legend, he was, well, not Franklin. Hamilton was a mere Treasury Secretary, even though he was the very first one. What is he doing among the presidents?

Hamilton is there because, unbeknown to most Americans today, he is the architect of the modern American economic system. Two years after becoming Treasury Secretary in 1789 at the outrageously young age of thirty-three, Hamilton submitted to the Congress the *Report on the Subject of Manufactures*, where he set out the economic development strategy for his young country. In the report, he argued that 'industries in their infancy', like the American ones, need to be protected and nurtured by government before they can stand on their own feet. Hamilton's report was not *just* about trade protectionism – he also argued for public investment in infrastructure (such as canals), development of the banking system, promotion of a government bond market – but protectionism was at the heart of his strategy. Given his views, were Hamilton finance minister of a developing country today, he would have been heavily criticized by the US Treasury Department for his heresy. His country might even have been refused a loan from the IMF and the World Bank.

The interesting thing, however, is that Hamilton was not alone in this. All the other 'dead presidents' would have met with the same disapproval from the US Treasury, the IMF, the World Bank and other defenders of the free-market faith today.

On the $1 bill is the first president, George Washington. At his inauguration ceremony, he insisted on wearing American clothes – specially woven in Connecticut for the occasion – rather than higher-quality British ones. Today, this would have been a violation of the proposed WTO rule on transparency in government procurement. And let's not forget that Washington was the one who appointed Hamilton as Treasury Secretary, and in full knowledge of what his view on economic policy was – Hamilton was Washington's aide-de-camp during the American War of Independence and his closest political ally after that.

On the $5 bill, we have Abraham Lincoln, a well-known protectionist, who during the Civil War raised tariffs to their highest level ever.[1] On the $50 bill, we have Ulysses Grant, the Civil War hero-turned president. In defiance of the British pressure on the USA to adopt free trade, he once remarked that 'within 200 years, when America has gotten out of protection all that it can offer, it too will adopt free trade'.

Benjamin Franklin did not share Hamilton's infant industry doctrine, but he insisted on high tariff protection for another reason. At the time, the existence of almost-free land in the US made it necessary for American manufacturers to offer wages around four times higher than the European average, as otherwise the workers would have run away to set up farms (this was no idle threat, given that many of them were farmers in their previous lives) (*see* Thing 10). Therefore, Franklin argued, the American manufacturers could not survive unless they were protected from low-wage competition – or what is known as 'social dumping' today – from Europe. This is exactly the logic that Ross Perot, the billionaire-turned-politician, used in order to oppose the NAFTA (North American Free Trade Agreement) in the 1992 presidential election campaign – a logic that 18.9 per cent of the American voters were happy to endorse.

But surely, you may say, Thomas Jefferson (on the rarely seen $2 bill) and Andrew Jackson (on the $20 bill), the patron saints of American free-market capitalism, would have passed the 'US Treasury Test'?

Thomas Jefferson may have been against Hamilton's protectionism but, unlike Hamilton, who supported the patent system, he argued strongly against patents. Jefferson believed that ideas are 'like air' and therefore should not be owned by anyone. Given the emphasis that most of today's free-market economists put on the protection of patents and other intellectual property rights, his views would have gone down like a lead balloon among them.

Then how about Andrew Jackson, that protector of the 'common man' and fiscal conservative (he paid off all federal government debts for the first time in US history)? Unfortunately for his fans, even he would not pass the test. Under Jackson, average industrial tariffs were in the region of 35–40 per cent. He was also notoriously anti-foreign. When in 1836 he cancelled the licence for the semi-public (second) Bank of the USA (it was 20 per cent owned by the US federal government), one of the main excuses was that it was 'too much' owned by foreign (mainly British) investors. And how much was too much? Only 30 per cent. If some developing country president today cancelled the licence for a bank because it was 30 per cent owned by the Americans, it would send the US Treasury into a fit.

So there we go. Every day, tens of millions of Americans go through the day paying for their taxis and buying their sandwiches with a Hamilton or a Lincoln, getting their change with Washingtons, not realizing that these revered politicians are nasty protectionists that most of their country's news media, conservative and liberal alike, love to lambast. New York bankers and Chicago university professors tut-tut through articles criticizing the anti-foreign antics of Hugo Chavez, the Venezuelan president, in copies of the *Wall Street Journal* bought with an Andrew Jackson, without realizing that he was far more anti-foreign than Chavez.

The dead presidents don't talk. But if they could, they would tell Americans and the rest of the world how the policies that their successors promote today are the exact opposite of what they used in order to transform a second-rate agrarian economy dependent on slave labour into the world's greatest industrial power.

Do as I say, not as I did

When reminded of the protectionist past of the US, free-market economists usually retort that the country succeeded despite, rather than because of, protectionism. They say that the country was destined to grow fast anyway, because it had been exceptionally well endowed with natural resources and received a lot of highly motivated and hard-working immigrants. It is also said that the country's large internal market somewhat mitigated the negative effects of protectionism, by allowing a degree of competition among domestic firms.

But the problem with this response is that, dramatic as it may be, the US is not the only country that has succeeded with policies that go against the free-market doctrine. In fact, as I shall elaborate below, most of today's rich countries have succeeded with such policies.[2] And, when they are countries with very different conditions, it is not possible to say that they all shared some special conditions that cancelled out the negative impacts of protectionism and other 'wrong' policies. The US may have benefited from a large domestic market, but then how about tiny Finland or Denmark? If you think the US benefited from abundance of natural resources, how do you explain the success of countries such as Korea and Switzerland that had virtually no natural resources to speak of? If immigration was a positive factor for the US, how about all those other countries – from Germany to Taiwan – that lost some of their best people to the US and other New World countries? The 'special conditions' argument simply does not work.

Britain, the country which many people think invented free trade, built its prosperity on the basis of policies similar to those that Hamilton promoted. This was not a coincidence. Although Hamilton was the first person to *theorize* the 'infant industry' argument, many of his policies were copied from Robert Walpole, the so-called first British Prime Minister, who ran the country between 1721 and 1742.

During the mid eighteenth century, Britain moved into the woollen manufacturing industry, the high-tech industry of the time that had been dominated by the Low Countries (what are Belgium and the Netherlands today), with the help of tariff protection, subsidies, and other supports that Walpole and his successors provided to the domestic woollen manufacturers. The industry soon provided Britain's main source of export earnings, which enabled the country to import the food and raw materials that it needed to launch the Industrial Revolution in the late eighteenth and the early nineteenth centuries. Britain adopted free trade only in the 1860s, when its industrial dominance was absolute. In the same way in which the US was the most protectionist country in the world during most of its phase of ascendancy (from the 1830s to the 1940s), Britain was one of the world's most protectionist countries during much of its own economic rise (from the 1720s to the 1850s).

Virtually all of today's rich countries used protectionism and subsidies to promote their infant industries. Many of them (especially Japan, Finland and Korea) also severely restricted foreign investment. Between the 1930s and the 1980s, Finland used to classify all enterprises with more than 20 per cent foreign ownership officially as 'dangerous enterprises'. Several of them (especially France, Austria, Finland, Singapore and Taiwan) used state-owned enterprises to promote key industries. Singapore, which is famous for its free-trade policies and welcoming attitudes towards foreign investors, produces over 20 per cent of its output through state-owned enterprises, when the international average is around 10 per cent. Nor did today's rich countries protect foreigners' intellectual property rights very well, if at all – in many of them it was legal to patent someone else's invention as long as that someone else was a foreigner.

There were exceptions of course. The Netherlands, Switzerland (until the First World War) and Hong Kong used little protectionism, but even these countries did not follow today's orthodox doctrines. Arguing that patents are artificial monopolies that go against the principle of free trade (a point which is strangely lost on most of today's free-trade economists), the Netherlands and Switzerland refused to protect patents until the early twentieth century. Even though it did not do it on such principled grounds, Hong Kong was until recently even more notorious for its violation of intellectual property rights than the former countries. I bet you know someone – or at least have a friend who knows someone – who has bought pirated computer software, a fake Rolex watch or an 'unofficial' Calvin & Hobbes T-shirt from Hong Kong.

Most readers may find my historical account counter-intuitive. Having been repeatedly told that free-market policies are the best for economic development, they would find it mysterious how most of today's countries could use all those supposedly bad policies – such as protectionism, subsidies, regulation and state ownership of industry – and still become rich.

The answer lies in the fact that those bad policies were in fact good policies, given the stage of economic development in which those countries were at the time, for a number of reasons. First is Hamilton's infant industry argument, which I explain in greater detail in the chapter 'My six-year-old son should get a job' in my earlier book *Bad Samaritans*. For the same reason why we send our children to school rather than making them compete with adults in the labour market, developing countries need to protect and nurture their producers before they acquire the capabilities to compete in the world market unassisted. Second, in the earlier stages of development, markets do not function very well for various reasons – poor transport, poor flow of information, the small size of the market that makes manipulation by big actors easier, and so on. This means that the government needs to regulate the market more actively and sometimes even deliberately create some markets. Third, in those stages, the government needs to do many things itself through state-owned enterprises because there are simply not enough capable private sector firms that can take up large-scale, high-risk projects (*see* Thing 12).

Despite their own history, the rich countries make developing countries open their borders and expose their economies to the full forces of global competition, using the conditions attached to their bilateral foreign aid and to the loans from international financial institutions that they control (such as the IMF and the World Bank) as well as the ideological influence that they exercise through intellectual dominance. In promoting policies that they did not use when they were developing countries themselves, they are saying to the developing countries, 'Do as I say, not as I did.'

A pro-growth doctrine that reduces growth

When the historical hypocrisy of the rich countries is pointed out, some defenders of the free market come back and say: 'Well, protectionism and other interventionist policies may have worked in nineteenth-century America or mid twentieth-century Japan, but haven't the developing countries monumentally screwed up when they tried such policies in the 1960s and 70s?' What may have worked in the past, they say, is not necessarily going to work today.

The truth is that developing countries did not do badly at all during the 'bad old days' of protectionism and state intervention in the 1960s and 70s. In fact, their economic growth performance during the period was far superior to that achieved since the 1980s under greater opening and deregulation.

Since the 1980s, in addition to rising inequality (which was to be expected from the pro-rich nature of the reforms – *see* *Thing 13*), most developing countries have experienced a significant deceleration in economic growth. Per capita income growth in the developing world fell from 3 per cent per year in the 1960s and 70s to 1.7 per cent during the 1980–2000 period, when there was the greatest number of free-market reforms. During the 2000s, there was a pick-up in the growth of the developing world, bringing the growth rate up to 2.6 per cent for the 1980–2009 period, but this was largely due to the rapid growth of China and India – two giants that, while liberalizing, did *not* embrace neo-liberal policies.

Growth performances in regions that have faithfully followed the neo-liberal recipe – Latin America and Sub-Saharan Africa – have been much inferior to what they had in the 'bad old days'. In the 1960s and 70s, Latin America grew at 3.1 per cent in per capita terms. Between 1980 and 2009, it grew at a rate just above one-third that – 1.1 per cent. And even that rate was partly due to the rapid growth of countries in the region that had explicitly rejected neo-liberal policies sometime earlier in the 2000s – Argentina, Ecuador, Uruguay and Venezuela. Sub-Saharan Africa grew at 1.6 per cent in per capita terms during the 'bad old days', but its growth rate was only 0.2 per cent between 1980 and 2009 (*see* *Thing 11*).

To sum up, the free-trade, free-market policies are policies that have rarely, if ever, worked. Most of the rich countries did not use such policies when they were developing countries themselves, while these policies have slowed down growth and increased income inequality in the developing countries in the last three decades. Few countries have become rich through free-trade, free-market policies and few ever will.

Thing 8

Capital has a nationality

What they tell you

The real hero of globalization has been the transnational corporation. Transnational corporations, as their name implies, are corporations that have gone beyond their original national boundaries. They may be still headquartered in the country where they were founded, but much of their production and research facilities are outside their home country, employing people, including many top decision-makers, from across the world. In this age of such nation-less capital, nationalistic policies towards foreign capital are at best ineffective and at worst counterproductive. If a country's government discriminates against them, transnational corporations will not invest in that country. The intention may be to help the national economy by promoting national firms, but such policies actually harm it by preventing the most efficient firms from establishing themselves in the country.

What they don't tell you

Despite the increasing 'transnationalization' of capital, most transnational companies in fact remain national companies with international operations, rather than genuinely nation-less companies. They conduct the bulk of their core activities, such as high-end research and strategizing, at home. Most of their top decision-makers are home-country nationals. When they have to shut down factories or cut jobs, they usually do it last at home for various political and, more importantly, economic reasons. This means that the home country appropriates the bulk of the benefits from a transnational corporation. Of course, their nationality is not the only thing that determines how corporations behave, but we ignore the nationality of capital at our peril.

Carlos Ghosn lives globalization

Carlos Ghosn was born in 1954 to Lebanese parents in the Brazilian city of Porto Velho. At the age of six, he moved with his mother to Beirut, Lebanon. After finishing secondary school there, he went to France and earned engineering degrees from two of the country's most prestigious educational institutions, École Polytechnique and École des Mines de Paris. During his eighteen years at the French tyre-maker Michelin, which he had joined in 1978, Ghosn acquired a reputation for effective management by turning the company's unprofitable South American operation around and by successfully managing the merger of its US subsidiary with Uniroyal Goodrich, which doubled the size of the company's US operation.

In 1996, Ghosn joined the state-owned French car-maker Renault and played a key role in reviving the company, affirming his reputation for ruthless cost-cutting and earning the sobriquet 'le cost killer', although his actual approach was more consensual than that name suggests. When Renault acquired Nissan, the loss-making Japanese car-maker, in 1999, Ghosn was sent to Japan to put Nissan back into shape. Initially, he faced stiff resistance to his un-Japanese way of management, such as sacking workers, but he turned the company completely around in a few years. After that, he has been so totally accepted by the Japanese that he has been made into a *manga* (comic book) character, the Japanese equivalent of beatification by the Catholic Church. In 2005, he stunned the world once again by going back to Renault as CEO and president, while staying on as a co-chairman of Nissan – a feat compared by some to a football coach managing two teams at the same time.

Carlos Ghosn's life story sums up the drama that is globalization. People migrate in search of a better life, sometimes literally to the other side of the world, as Ghosn's family did. Some of the migrants, like Ghosn's mother, go back home. This is a big contrast to the days when, for example, Italian immigrants to the US refused to teach their children Italian, as they were so determined not to go back to Italy and wanted their children totally assimilated. Many youngsters from poorer countries with ambition and brains now go to a richer country to study, as Ghosn did. These days, many managers work for a company based in a foreign country, which often means living and working in yet another foreign country (or two) because your company is transnational. Ghosn, a Lebanese Brazilian return-migrant, worked in Brazil, the US and Japan for two French companies.

In this globalized world, the argument goes, nationality of capital is meaningless. Corporations may have started and still be headquartered in a particular country, but they have broken out of their national borders. They now locate their activities wherever the return is the greatest. For example, Nestlé, the Swiss food giant, may be headquartered in the Swiss city of Vevey, but less than 5 per cent of its output is produced in Switzerland. Even if we consider Nestlé's 'home' to be Europe, rather than Switzerland, its home base accounts for only around 30 per cent of its earnings. It is not just the relatively low-grade activities such as production that transnational corporations are conducting outside their home countries. These days, even top-end activities such as R&D are often located outside the home country – increasingly in developing countries, such as China and India. Even their top managers are drawn, like Ghosn, from an international pool of talent, rather than from exclusively national pools.

The upshot is that a company has no national loyalty any more. A business will do what it has to do in order to increase its profit, even if it means hurting its home country by shutting plants down, slashing jobs, or even bringing in foreign workers. Given this, many people argue, it is unwise to put restrictions on foreign ownership of companies, as many governments used to. As long as the company generates wealth and jobs within its borders, the country should not care whether the company is owned by its citizens or foreigners. When all major companies are ready to move anywhere in search of profit opportunities, making investment by foreign companies difficult means that your country is not going to benefit from those foreign companies that have identified good investment prospects in your country. It all makes sense, doesn't it?

Chrysler – American, German, American (again) and (becoming) Italian

In 1998, Daimler-Benz, the German automobile company, and Chrysler, the US car-maker, were merged. It was really a takeover of Chrysler by Daimler-Benz. But when the merger was announced, 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. That was, however, only for the first few years. Soon, the Germans vastly outnumbered the Americans on the board – usually ten to twelve to just one or two Americans, depending on the year.

Unfortunately, the takeover was not a great success, and in 2007 Daimler-Benz sold Chrysler off to Cerberus, an American private equity fund. Cerberus, being an American company, made up Chrysler's board of directors mostly with Americans (with some representation from Daimler, which still held a 19.9 per cent stake).

In the event, Cerberus failed to turn the company around and Chrysler went bankrupt in 2009. It was restructured with US federal government financial aid and a major equity investment by Fiat, the Italian car-maker. When Fiat became the leading shareholder, it made Sergio Marchionne, the CEO of Fiat, also the new CEO of Chrysler and appointed another Fiat manager to Chrysler's nine-member board of directors. Given that Fiat has only a 20 per cent stake at the moment but has the option to increase it to 35 per cent and eventually to 51 per cent, it is highly likely that the proportion of Italians on the board will increase over time, with the increase in Fiat's ownership share.

So Chrysler, once one of the quintessential American companies, has in the last decade come to be run by Germans, Americans (again) and (increasingly) Italians. There is no such thing as 'nation-less' capital. When taken over by a foreign company, even mighty (former-)American firms end up being run by foreigners (but then that is what takeover means, when you think about it). In most companies, however transnational their operations may seem, the top decision-makers still remain the citizens of the home country – that is, the country where ownership resides – despite the fact that long-distance management (when the acquiring company does not dispatch top managers to the acquired firm) can reduce management efficiency, while dispatching top managers to a foreign country is expensive, especially when the physical and the cultural distances between the two countries are great. Carlos Ghosn is very much an exception that proves the rule.

It is not just in terms of the appointment of top decision-makers that corporations have a ‘home bias’. Home bias is also very strong in research and development, which are at the core of a company’s competitive strengths in most advanced industries. Most of a corporation’s R&D activities stay at home. Insofar as they are relocated abroad, it is usually to other developed countries, and at that with a heavy ‘regional’ bias (the regions here meaning North America, Europe and Japan, which is a region unto itself in this respect). Recently an increasing number of R&D centres have been set up in developing countries, such as China and India, but the R&D they conduct tends to be at the lowest levels of sophistication.

Even in terms of production, arguably the easiest thing that a company does and therefore the most likely candidate for relocation abroad, most transnational corporations are still firmly based in their home countries. There are odd examples of firms, for instance Nestlé, which produce most of their outputs abroad, but they are very much the exception. Among US-based transnational corporations, less than one-third of the output of manufacturing firms is produced overseas. In the case of Japanese companies, the ratio is well below 10 per cent. In Europe, the ratio has risen fast recently, but most overseas production by European firms is within the European Union, so it should be understood more as a process of creating national firms for a new nation called Europe than as a process of European firms going truly transnational.

In short, few corporations are truly transnational. The vast majority of them still produce the bulk of their outputs in their home countries. Especially in terms of high-grade activities such as strategic decision-making and higher-end R&D, they remain firmly centred at their home countries. The talk of a borderless world is highly exaggerated.[1]

Why is there a home-country bias?

Why is there a home-country bias in this globalized world? The free-market view is that nationality of capital does not – and should not – matter, because companies have to maximize profit in order to survive and therefore that patriotism is a luxury they can ill afford. Interestingly, many Marxists would agree. They also believe that capital willingly destroys national borders for greater profits and for the expanded reproduction of itself. The language is radically different, but the message is the same – money is money, so why should a company do less profitable things simply because they are good for its home country?

However, there are good reasons why companies act with home-country biases. To begin with, like most of us, top business managers feel some personal obligations to the society they come from. They may frame such obligations in many different ways – patriotism, community spirit, *noblesse oblige*, or wanting to 'return something to the society that has made them what they are today' – and may feel them to different degrees. But the point is that they do feel them. And insofar as most top decision-makers in most companies are home-country nationals, there is bound to be some home-country bias in their decisions. Although free-market economists dismiss any motive other than pure self-seeking, 'moral' motives are real and are much more important than they lead us to believe (*see* Thing 5).

On top of those personal feelings of managers, a company often has real historical obligations to the country in which it has 'grown up'. Companies, especially (although not exclusively) in the early stages of their development, are often supported with public money, directly and indirectly (*see* Thing 7). Many of them receive direct subsidies for particular types of activities, such as equipment investment or worker training. They sometimes even get bailed out with public money, as Toyota was in 1949, Volkswagen in 1974 and GM in 2009. Or they may get indirect subsidies in the form of tariff protection or statutory monopoly rights.

Of course, companies often fail to mention, and even actively hide, such history, but there is an unspoken understanding among the relevant parties that companies do have some moral obligations to their home countries because of these historical debts. This is why national companies are much more open to moral suasion by the government and the public than foreign companies are, when they are expected, although cannot be legally obliged, to do something for the country against their (at least short-term) interests. For example, it was reported in October 2009 that South Korea's financial supervisory agency was finding it impossible to persuade foreign-owned banks to lend more to small and medium-sized companies, even though they, like the nationally owned banks, had already signed an MOU (memorandum of understanding) about that with the agency, when the global financial crisis broke out in the autumn of 2008.

Important though the moral and historical reasons are, by far the most important reason for home-country bias is economic – the fact that the core capabilities of a company cannot be easily taken across the border.

Usually, a company becomes transnational and sets up activities in foreign countries because it possesses some technological and/or organizational competences that the firms operating in the host countries do not possess. These competences are usually embodied in people (e.g., managers, engineers, skilled workers), organizations (e.g., internal company rules, organizational routines, 'institutional memory') and networks of related firms (e.g., suppliers, financiers, industrial associations or even old-boy networks that cut across company boundaries), all of which cannot be easily transported to another country.

Most machines may be moved abroad easily, but it is much more costly to move skilled workers or managers. It is even more difficult to transplant organizational routines or business networks on to another country. For example, when

Japanese automobile companies started setting up subsidiaries in Southeast Asia in the 1980s, they asked their subcontractors also to set up their own subsidiaries, as they needed reliable subcontractors. Moreover, these intangible capabilities embodied in people, organizations and networks often need to have the right institutional environment (the legal system, informal rules, business culture) in order to function well. However powerful it may be, a company cannot transport its institutional surroundings to another country.

For all these reasons, the most sophisticated activities that require high levels of human and organizational competences and a conducive institutional environment tend to stay at home. Home biases do not exist simply because of emotional attachments or historical reasons. Their existence has good economic bases.

'Prince of darkness' changes his mind

Lord Peter Mandelson, the *de facto* deputy prime minister of the UK government at the time of writing (early 2010), has a bit of a reputation for his Machiavellian politics. A grandson of the highly respected Labour politician Herbert Morrison, and a TV producer by profession, Mandelson was the chief spin doctor behind the rise of the so-called New Labour under Tony Blair. His famous ability to sense and exploit shifts in political moods and accordingly organize an effective media campaign, combined with his ruthlessness, earned him the nickname 'prince of darkness'.

After a high-profile but turbulent cabinet career, marred by two resignations due to suspected corruption scandals, Mandelson quit British politics and moved to Brussels to become European Commissioner for Trade in 2004. Building on the image of a pro-business politician, gained during his brief spell as the UK's Secretary of State for Trade and Industry back in 1998, Mandelson established a firm reputation as one of the world's leading advocates of free trade and investment.

So it sent out a shockwave, when Mandelson, who had made a surprise comeback to British politics and become Business Secretary in early 2009, said in an interview with the *Wall Street Journal* in September 2009 that, thanks to Britain's permissive attitude towards foreign ownership, 'UK manufacturing could be a loser', even though he added the proviso that this was 'over a lengthy period of time, certainly not overnight'.

Was it a typical Mandelson antic, with his instinct telling him that this was the time to play the nationalist card? Or did he finally cotton on to something that he and other British policy-makers should have realized a long time ago – that excessive foreign ownership of a national economy can be harmful?

Now, it may be argued, the fact that firms have a home-country bias does *not* necessarily mean that countries should put restrictions on foreign investment. True, given the home bias, investment by a foreign company may not be in the most desirable activities, but an investment is an investment and it will still increase output and create jobs. If you put restrictions on what foreign investors can do – for example, by telling them that they cannot invest in certain 'strategic' industries, by forbidding them from holding a majority share or demanding that they transfer technologies – foreign investors will simply go somewhere else and you will lose the jobs and the wealth that they would have created. Especially for developing countries, which do not have many national firms that can make similar investments, rejecting foreign investment because it is foreign many people believe is frankly irrational. Even if they get only lower-grade activities such as assembly operation, they are still better off with the investment than without it.

This reasoning is correct in its own terms, but there are more issues that need to be considered before we conclude that there should be no restriction on foreign investment (here, we put aside portfolio investment, which is investment in company shares for financial gains without involvement in direct management, and focus on foreign direct investment, which is usually defined as acquisition of more than 10 per cent of a company's shares with an intent to get involved in management).

First of all, we need to remember that a lot of foreign investment is what is known as 'brownfield investment,' that is, acquisition of existing firms by a foreign firm, rather than 'greenfield investment', which involves a foreign firm setting up new production facilities. Since the 1990s, brownfield investment has accounted for over half of total world foreign direct investment (FDI), even reaching 80 per cent in 2001, at the height of the international mergers and acquisitions (M&A) boom. This means that the majority of FDI involves taking control of existing firms, rather than the creation of new output and jobs. Of course, the new owners may inject better managerial and technological capabilities and revive an ailing company – as seen in the case of Nissan under Carlos Ghosn – but very often such an acquisition is made with a view to utilizing capabilities that already exist in the acquired company rather than creating new ones. And, more importantly, once your national firm is acquired by a foreign firm, the home bias of the acquiring company will in the long run impose a ceiling on how far it progresses in the internal pecking order of the acquiring company.

Even in the case of greenfield investment, home-country bias is a factor to consider. Yes, greenfield investment creates new productive capabilities, so it is by definition better than the alternative, that is, no investment. However, the question that policy-makers need to consider before accepting it is how it is going to affect the future trajectory of their national economy. Different activities have different potentials for technological innovation and productivity growth, and therefore what you do today influences what you will be doing in the future and what you will get out of it. As a popular saying among American industrial policy experts in the 1980s went, we cannot pretend that it does not matter whether you produce potato chips, wood chips or microchips. And the chance is that a foreign company is more likely to produce potato chips or wood chips than microchips in your country.

Given this, especially for a developing country, whose national firms are still underdeveloped, it may be better to restrict FDI at least in some industries and try to raise national firms so that they become credible alternative investors to foreign companies. This will make the country lose some investment in the short run, but it may enable it to have more higher-end activities within its borders in the long run. Or, even better, the developing country government can allow foreign investment under conditions that will help the country upgrade the capabilities of national firms faster – for example, by requiring joint ventures (which will promote the transfer of managerial techniques), demanding more active technology transfer, or mandating worker training.

Now, saying that foreign capital is likely to be less good for your country than your own national capital is not to say that we should always prefer national capital to foreign capital. This is because its nationality is not the only thing that determines the behaviour of capital. The intention and the capability of the capital in question also matter.

Suppose that you are thinking of selling a struggling nationally owned car company. Ideally, you want the new owner to have the willingness and the ability to upgrade the company in the long run. The prospective buyer is more likely to have the technological capabilities to do so when it is an already established automobile producer, whether national or foreign, rather than when it is finance capital, such as a private equity fund.

In recent years, private equity funds have played an increasingly important role in corporate acquisitions. Even though they have no in-house expertise in particular industries, they may, in theory, acquire a company for the long term and hire industry experts as managers and ask them to upgrade its capabilities. However, in practice, these funds usually have no intention to upgrade the acquired company for the long term. They acquire firms with a view to selling them on in three to five years after restructuring them into profitability. Such restructuring, given the time horizon, usually involves cutting costs (especially sacking workers and refraining from long-term investments), rather than raising capabilities. Such restructuring is likely to hurt the long-term prospects of the company by weakening its ability to generate productivity growth. In the worst cases, private equity funds may acquire companies with the explicit intention to engage in asset-stripping, selling the valuable assets of a company without regard to its long-term future. What the now-notorious Phoenix Venture Holdings did to the British car-maker Rover, which they had bought from BMW, is a classic example of this (the so-called 'Phoenix Four' became particularly notorious for paying themselves huge salaries and their friends exorbitant consultancy fees).

Of course, this is not to say that firms that are already operating in the industry will always have the intention to upgrade the acquired company for the long term either. When GM acquired a series of smaller foreign car companies – such as Sweden's Saab and Korea's Daewoo – during the decade before its bankruptcy in 2009, the intention was to live off the technologies accumulated by these companies, rather than to upgrade them (*see* *Thing 18*). Moreover, recently the distinction between industrial capital and finance capital has come to be blurred, with industrial companies such as GM and GE making more profits in finance than in industry (*see* *Thing 22*), so the fact that the acquiring firm operates in a particular industry is not a guarantee of a long-term commitment to that industry.

So, if a foreign company operating in the same industry is buying up your national company with a serious long-term commitment, selling it to that company may be better than selling it to your own national private equity fund. However, other things being equal, the chance is that your national company is going to act in a way that is more favourable to your national economy.

Thus, despite the globalization rhetoric, the nationality of a firm is still a key to deciding where its high-grade activities, such as R&D and strategizing, are going to be located. Nationality is not the only determinant of firm behaviour, so we need to take into account other factors, such as whether the investor has a track record in the industry concerned and how strong its long-term commitment to the acquired company really is. While a blind rejection of foreign capital is wrong, it would be very naïve to design economic policies on the myth that capital does not have national roots any more. After all, Lord Mandelson's belatedly found reservations turn out to have a serious basis in reality.

Thing 9

We do not live in a post-industrial age

What they tell you

Our economy has been fundamentally transformed during the last few decades. Especially in the rich countries, manufacturing industry, once the driving force of capitalism, is not important any more. With the natural tendency for the (relative) demand for services to rise with prosperity and with the rise of high-productivity knowledge-based services (such as banking and management consulting), manufacturing industries have gone into decline in all rich countries. These countries have entered the 'post-industrial' age, where most people work in services and most outputs are services. The decline of manufacturing is not only something natural that we needn't worry about but something that we should really celebrate. With the rise of knowledge-based services, it may be better even for some developing countries to skip those doomed manufacturing activities altogether and leapfrog straight to a service-based post-industrial economy.

What they don't tell you

We may be living in a post-industrial society in the sense that most of us work in shops and offices rather than in factories. But we have not entered a post-industrial stage of development in the sense that industry has become unimportant. Most (although not all) of the shrinkage in the share of manufacturing in total output is not due to the fall in the absolute quantity of manufactured goods produced but due to the fall in their prices relative to those for services, which is caused by their faster growth in productivity (output per unit of input). Now, even though de-industrialization is mainly due to this differential productivity growth across sectors, and thus may not be something negative in itself, it has negative consequences for economy-wide productivity growth and for the balance of payments, which cannot be ignored. As for the idea that developing countries can largely skip industrialization and enter the post-industrial phase directly, it is a fantasy. Their limited scope for productivity growth makes services a poor engine of growth. The low tradability of services means that a more service-based economy will have a lower ability to export. Lower export earnings means a weaker ability to buy advanced technologies from abroad, which in turn leads to a slower growth.

Is there anything that is not made in China?

One day, Jin-Gyu, my nine-year-old son (yes, that's the one who appeared as 'my six-year-old son' in my earlier book *Bad Samaritans* – really quite a versatile actor, he is) came and asked me: 'Daddy, is there anything that is not made in China?' I told him that, yes, it may not look that way, but other countries still make things. I then struggled to come up with an example. I was about to mention his 'Japanese' Nintendo DSi game console, but then I remembered seeing 'Made in

China' on it. I managed to tell him that some mobile phones and flat-screen TVs are made in Korea, but I could not think of many other things that a nine-year-old would recognize (he is still too young for things like BMW). No wonder China is now called the 'workshop of the world'.

It is hard to believe, but the phrase 'workshop of the world' was originally coined for Britain, which today, according to Nicolas Sarkozy, the French president, has 'no industry'. Having successfully launched the Industrial Revolution before other countries, Britain became such a dominant industrial power by the mid nineteenth century that it felt confident enough to completely liberalize its trade (*see Thing 7*). In 1860, it produced 20 per cent of world manufacturing output. In 1870, it accounted for 46 per cent of world trade in manufactured goods. The current Chinese share in world exports is only around 17 per cent (as of 2007), even though 'everything' seems to be made in China, so you can imagine the extent of British dominance then.

However, Britain's pole position was shortlived. Having liberalized its trade completely around 1860, its relative position started declining from the 1880s, with countries such as the US and Germany rapidly catching up. It lost its leading position in the world's industrial hierarchy by the time of the First World War, but the dominance of manufacturing in the British economy itself continued for a long time afterwards. Until the early 1970s, together with Germany, Britain had one of the world's highest shares of manufacturing employment in total employment, at around 35 per cent. At the time, Britain was the quintessential manufacturing economy, exporting manufactured goods and importing food, fuel and raw materials. Its manufacturing trade surplus (manufacturing exports minus manufacturing imports) stayed consistently between 4 per cent and 6 per cent of GDP during the 1960s and 70s.

Since the 1970s, however, the British manufacturing sector has shrunk rapidly in importance. Manufacturing output as a share of Britain's GDP used to be 37 per cent in

1950. Today, it accounts for only around 13 per cent. Manufacturing's share in total employment fell from around 35 per cent in the early 1970s to just over 10 per cent.[1] Its position in international trade has also dramatically changed. These days, Britain runs manufacturing trade deficits in the region of 2–4 per cent of GDP per year. What has happened? Should Britain be worried?

The predominant opinion is that there is nothing to worry about. To begin with, it is not as if Britain is the only country in which these things have happened. The declining shares of manufacturing in total output and employment – a phenomenon known as de-industrialization – is a natural occurrence, many commentators argue, common to all rich countries (accelerated in the British case by the finding of North Sea oil). This is widely believed to be because, as they become richer, people begin to demand more services than manufactured goods. With falling demand, it is natural that the manufacturing sector shrinks and the country enters the post-industrial stage. Many people actually celebrate the rise of services. According to them, the recent expansion of knowledge-based services with rapid productivity growth – such as finance, consulting, design, computing and information services, R&D – means that services have replaced manufacturing as the engine of growth, at least in the rich countries. Manufacturing is now a low-grade activity that developing countries such as China perform.

Computers and haircuts: why de-industrialization happens

Have we really entered the post-industrial age? Is manufacturing irrelevant now? The answers are: 'only in some ways', and 'no'.

It is indisputable that much lower proportions of people in the rich countries work in factories than used to be the case. There was a time in the late nineteenth and early twentieth centuries when in some countries (notably Britain and Belgium) around 40 per cent of those employed worked in the manufacturing industry. Today, the ratio is at most 25 per cent, and in some countries (especially the US, Canada and Britain) barely 15 per cent.

With so much fewer people (in proportional terms) working in factories, the nature of society has changed. We are partly formed by our work experiences (a point which most economists fail to recognize), so where and how we work influences who we are. Compared to factory workers, office workers and shop assistants do much less physical work and, not having to work with conveyor belts and other machines, have more control over their labour process. Factory workers cooperate more closely with their colleagues during work and outside work, especially through trade union activities. In contrast, people working in shops and offices tend to work on more individual bases and are not very unionized. Shop assistants and some office workers interact directly with customers, whereas factory workers never see their customers. I am not enough of a sociologist or a psychologist to say anything profound in this regard, but all this means that people in today's rich countries not only work differently from but are different from their parents and grandparents. In this way, today's rich countries have become post-industrial societies in the social sense.

However, they have *not* become post-industrial in the economic sense. Manufacturing still plays the leading role in their economies. In order to see this point, we first need to understand why de-industrialization has happened in the rich countries.

A small, but not negligible, part of de-industrialization is due to optical illusions, in the sense that it reflects changes in statistical classification rather than changes in real activities. One such illusion is due to the outsourcing of some activities that are really services in their physical nature but used to be provided in-house by manufacturing firms and thus classified as manufacturing output (e.g., catering, cleaning, technical supports). When they are outsourced, recorded service outputs increase without a real increase in service activities. Even though there is no reliable estimate of its magnitude, experts agree that outsourcing has been a significant source of de-industrialization in the US and Britain, especially during the 1980s. In addition to the outsourcing effect, the extent of manufacturing contraction is exaggerated by what is called the 'reclassification effect'.[2] A UK government report estimates that up to 10 per cent of the fall in manufacturing employment between 1998 and 2006 in the UK may be accounted for by some manufacturing firms, seeing their service activities becoming predominant, applying to the government statistical agency to be reclassified as service firms, even when they are still engaged in some manufacturing activities.

One cause of genuine de-industrialization has recently attracted a lot of attention. It is the rise of manufacturing imports from low-cost developing countries, especially China. However dramatic it may look, it is not the main explanation for de-industrialization in the rich countries. China's exports did not make a real impact until the late 1990s, but the de-industrialization process had already started in the 1970s in most rich countries. Most estimates show that the rise of China as the new workshop of the world can explain only around 20 per cent of de-industrialization in the rich countries that has happened so far.

Many people think that the remaining 80 per cent or so can be largely explained by the natural tendency of the (relative) demand for manufactured goods to fall with rising prosperity. However, a closer look reveals that this demand effect is actually very small. It looks as if we are spending ever higher shares of our income on services not because we are consuming ever more services in absolute terms but mainly because services are becoming ever more expensive in relative terms.

With the (inflation-adjusted) amount of money you paid to get a PC ten years ago, today you can probably buy three, if not four, computers of equal or even greater computing power (and certainly smaller size). As a result, you probably have two, rather than just one, computers. But, even with two computers, the portion of your income that you spend on computers has gone down quite a lot (for the sake of argument, I am assuming that your income, after adjusting for inflation, is the same). In contrast, you are probably getting the same number of haircuts as you did ten years ago (if you haven't gone thin on top, that is). The price of haircuts has probably gone up somewhat, so the proportion of your income that goes to your haircuts is greater than it was ten years ago. The result is that it looks as if you are spending a greater (smaller) portion of your income on haircuts (computers) than before, but the reality is that you are actually consuming more computers than before, while your consumption of haircuts is the same.

Indeed, if you adjust for the changes in relative prices (or, to use technical jargon, if you measure things in *constant* prices), the decline of manufacturing in the rich countries has been far less steep than it appears to be. For example, in the case of Britain, the share of manufacturing in total output, without counting the relative price effects (to use the jargon, in *current* prices), fell by over 40 per cent between 1955 and 1990 (from 37 per cent to 21 per cent). However, when taking the relative price effects into account, the fall was only by just over 10 per cent (from 27 per cent to 24 per cent).[3] In other words, the *real* demand effect – that is the demand effect after taking relative price changes into account – is small.

Then why are the relative prices of manufactured goods falling? It is because manufacturing industries tend to have faster productivity growth than services. As the output of the manufacturing sector increases faster than the output of the service sector, the prices of the manufactured goods relative to those of services fall. In manufacturing, where mechanization and the use of chemical processes are much easier, it is easier to raise productivity than in services. In contrast, by their very nature, many service activities are inherently impervious to productivity increase *without diluting the quality of the product*.

In some cases, the very attempt to increase productivity will destroy the product itself. If a string quartet trots through a twenty-seven-minute piece in nine minutes, would you say that its productivity has trebled?

For some other services, the apparent higher productivity is due to the debasement of the product. A teacher can raise her apparent productivity by four times by having four times as many pupils in her classroom, but the quality of her 'product' has been diluted by the fact that she cannot pay as much individual attention as before. A lot of the increases in retail service productivity in countries such as the US and Britain has been bought by lowering the quality of the retail service itself while ostensibly offering cheaper shoes, sofas and apples: there are fewer sales assistants at shoe stores, so you wait twenty minutes instead of five; you have to wait four weeks, rather than two, for the delivery of your new sofa and probably also have to take a day off work because they will only deliver 'sometime between 8 a.m. and 6 p.m.'; you spend much more time than before driving to the new supermarket and walking through the now longer aisles when you get there, because those apples are cheaper than in the old supermarket only because the new supermarket is in the middle of nowhere and thus can have more floor space.

There are some service activities, such as banking, which have greater scope for productivity increase than other services. However, as revealed by the 2008 financial crisis, much of the productivity growth in those activities was due not to a real rise in their productivity (e.g., reduction in trading costs due to better computers) but to financial innovations that obscured (rather than genuinely reduced) the riskiness of financial assets, thereby allowing the financial sector to grow at an unsustainably rapid rate (*see* *Thing 22*).

To sum up, the fall in the share of manufacturing in total output in the rich countries is *not* largely due to the fall in (relative) demand for manufactured goods, as many people think. Nor is it due mainly to the rise of manufactured exports from China and other developing countries, although that has had big impacts on some sectors. It is instead the falling relative prices of the manufactured goods due to faster growth in productivity in the manufacturing sector that is the main driver of the de-industrialization process. Thus, while the citizens of the rich countries may be living in post-industrial societies in terms of their *employment*, the importance of manufacturing in terms of *production* in those economies has not been diminished to the extent that we can declare a post-industrial age.

Should we worry about de-industrialization?

But if de-industrialization is due to the very dynamism of a country’s manufacturing sector, isn’t it a good thing?

Not necessarily. The fact that de-industrialization is mainly caused by the *comparative* dynamism of the manufacturing sector *vis-à-vis* the service sector does not tell us anything about how well it is doing compared to its counterparts in other countries. If a country’s manufacturing sector has slower productivity growth than its counterparts in other countries, it will become internationally uncompetitive, leading to balance of payments problems in the short run and falling standards of living in the long term. In other words, de-industrialization may be accompanied by either economic success or failure. Countries should not be lulled into a false sense of security by the fact that de-industrialization is due to *comparative* dynamism of the manufacturing sector, as even a manufacturing sector that is very undynamic by international standards can be (and usually is) more dynamic than the service sector of the same country.

Whether or not a country's manufacturing sector is dynamic by international standards, the shrinkage of the relative weight of the manufacturing sector has a negative impact on productivity growth. As the economy becomes dominated by the service sector, where productivity growth is slower, productivity growth for the whole economy will slow down. Unless we believe (as some do) that the countries experiencing de-industrialization are now rich enough not to need more productivity growth, productivity slowdown is something that countries should get worried about – or at least reconcile themselves to.

De-industrialization also has a negative effect on a country's balance of payments because services are inherently more difficult to export than manufactured goods. A balance of payments deficit means that the country cannot 'pay its way' in the world. Of course, a country can plug the hole through foreign borrowing for a while, but eventually it will have to lower the value of its currency, thereby reducing its ability to import and thus its living standard.

At the root of the low 'tradability' of services lies the fact that, unlike manufactured goods that can be shipped anywhere in the world, most services require their providers and consumers to be in the same location. No one has yet invented ways to provide a haircut or house-cleaning long-distance. Obviously, this problem will be solved if the service provider (the hairdresser or the cleaner in the above examples) can move to the customer's country, but that in most cases means immigration, which most countries restrict heavily (*see* Thing 3). Given this, a rising share of services in the economy means that the country, other things being equal, will have lower export earnings. Unless the exports of manufactured goods rise disproportionately, the country won't be able to pay for the same amount of imports as before. If its de-industrialization is of a negative kind accompanied by weakening international competitiveness, the balance of payments problem could be even more serious, as the manufacturing sector then won't be able to increase its exports.

Not all services are equally non-tradable. The knowledge-based services that I mentioned earlier – banking, consulting, engineering, and so on – are highly tradable. For example, in Britain since the 1990s, exports of knowledge-based services have played a crucial role in plugging the balance of payments gap left behind by de-industrialization (and the fall in North Sea oil exports, which had enabled the country – just – to survive the negative balance of payments consequences of de-industrialization during the 1980s).

However, even in Britain, which is most advanced in the exports of these knowledge-based services, the balance of payments surplus generated by those services is well below 4 per cent of GDP, just enough to cover the country's manufacturing trade deficits. With the likely strengthening of global financial regulation as a consequence of the 2008 world financial crisis, it is unlikely that Britain can maintain this level of trade surplus in finance and other knowledge-based services in the future. In the case of the US, supposedly another model post-industrial economy, the trade surplus in knowledge-based services is actually less than 1 per cent of GDP – nowhere near enough to make up for its manufacturing trade deficits, which are around 4 per cent of GDP.[4] The US has been able to maintain such a large manufacturing trade deficit only because it could borrow heavily from abroad – an ability that can only shrink in the coming years, given the changes in the world economy – and not because the service sector stepped in to fill the gap, as in the British case. Moreover, it is questionable whether the strengths of the US and Britain in the knowledge-based services can be maintained over time. In services such as engineering and design, where insights gained from the production process are crucial, a continuous shrinkage of the industrial base will lead to a decline in the quality of their (service) products and a consequent loss in export earnings.

If Britain and the US – two countries that are supposed to be the most developed in the knowledge-based services – are unlikely to meet their balance of payments needs in the long run through the exports of these services, it is highly unlikely that other countries can.

Post-industrial fantasies

Believing de-industrialization to be the result of the change of our engine of growth from manufacturing to services, some have argued that developing countries can largely skip industrialization and move directly to the service economy. Especially with the rise of service offshoring, this view has become very popular among some observers of India. Forget all those polluting industries, they say, why not go from agriculture to services directly? If China is the workshop of the world, the argument goes, India should try to become the 'office of the world'.

However, it is a fantasy to think that a poor country can develop mainly on the basis of the service sector. As pointed out earlier, the manufacturing sector has an inherently faster productivity growth than the service sector. To be sure, there are some service industries that have rapid productivity growth potential, notably the knowledge-based services that I mentioned above. However, these are service activities that mainly serve manufacturing firms, so it is very difficult to develop those industries without first developing a strong manufacturing base. If you base your development largely on services from early on, your long-term productivity growth rate is going to be much slower than when you base it on manufacturing.

Moreover, we have already seen that, given that services are much less tradable, countries specializing in services are likely to face much more serious balance of payments problems than countries that specialize in manufacturing. This is bad enough for a developed country, where balance of payments problems will lower standards of living in the long run. However, it is seriously detrimental for a developing country. The point is that, in order to develop, a developing country has to import superior technologies from abroad (either in the form of machines or in the form of technology licensing). Therefore, when it has a balance of payments problem, its very ability to upgrade and thus develop its economy by deploying superior technologies is hampered.

As I say these negative things about economic development strategies based on services, some of you may say: what about countries like Switzerland and Singapore? Haven't they developed on the basis of services?

However, these economies are not what they are reported to be either. They are in fact manufacturing success stories. For example, many people think that Switzerland lives off the stolen money deposited in its banks by Third World dictators or by selling cowbells and cuckoo clocks to Japanese and American tourists, but it is actually one of the most industrialized economies in the world. We don't see many Swiss manufactured products around because the country is small (around 7 million people), which makes the total amount of Swiss manufactured goods rather small, and because its producers specialize in producer goods, such as machinery and industrial chemicals, rather than consumer goods that are more visible. But in per capita terms, Switzerland has the highest industrial output in the world (it could come second after Japan, depending on the year and the data you look at). Singapore is also one of the five most industrialized economies in the world (once again, measured in terms of manufacturing value-added per head). Finland and Sweden make up the rest of the top five. Indeed, except for a few places such as the Seychelles that has a very small population and exceptional resources for tourism (85,000 people with around $9,000 per capita income), no country has so far achieved even a decent (not to speak of high) living standard by relying on services and none will do so in the future.

To sum up, even the rich countries have not become unequivocally post-industrial. While most people in those countries do not work in factories any more, the manufacturing sector's importance in their production systems has not fallen very much, once we take into account the relative price effects. But even if de-industrialization is not necessarily a symptom of industrial decline (although it often is), it has negative effects for long-term productivity growth and the balance of payments, both of which need reckoning. The myth that we now live in a post-industrial age has made many governments ignore the negative consequences of de-industrialization.

As for the developing countries, it is a fantasy to think that they can skip industrialization and build prosperity on the basis of service industries. Most services have slow productivity growth and most of those services that have high productivity growth are services that cannot be developed without a strong manufacturing sector. Low tradability of services means that a developing country specializing in services will face a bigger balance of payments problem, which for a developing country means a reduction in its ability to upgrade its economy. Post-industrial fantasies are bad enough for the rich countries, but they are positively dangerous for developing countries.

Thing 10

The US does not have the highest living standard in the world

What they tell you

Despite its recent economic problems, the US still enjoys the highest standard of living in the world. At market exchange rates, there are several countries that have a higher per capita income than the US. However, if we consider the fact that the same dollar (or whatever common currency we choose) can buy more goods and services in the US than in other rich countries, the US turns out to have the highest living standard in the world, barring the mini-city-state of Luxemburg. This is why other countries seek to emulate the US, illustrating the superiority of the free-market system, which the US most closely (if not perfectly) represents.

What they don’t tell you

The average US citizen does have greater command over goods and services than his counterpart in any other country in the world except Luxemburg. However, given the country’s high inequality, this average is less accurate in representing how people live than the averages for other countries with a more equal income distribution. Higher inequality is also behind the poorer health indicators and worse crime statistics of the US. Moreover, the same dollar buys more things in the US than in most other rich countries mainly because it has cheaper services than in other comparable countries, thanks to higher immigration and poorer employment conditions. Furthermore, Americans work considerably longer than Europeans. Per hour worked, their command over goods and services is smaller than that of several European countries. While we can debate which is a better lifestyle – more material goods with less leisure time (as in the US) or fewer material goods with more leisure time (as in Europe) – this suggests that the US does not have an unambiguously higher living standard than comparable countries.

The roads are not paved with gold

Between 1880 and 1914, nearly 3 million Italians migrated to the US. When they arrived, many of them were bitterly disappointed. Their new home was not the paradise they had thought it would be. It is said that many of them wrote back home, saying 'not only are the roads not paved with gold, they are not paved at all; in fact, we are the ones who are supposed to pave them'.

Those Italian immigrants were not alone in thinking that the US is where dreams come true. The US became the richest country in the world only around 1900, but even in the early days of its existence, it had a strong hold on the imagination of poor people elsewhere. In the early nineteenth century, US per capita income was still only around the European average and something like 50 per cent lower than that of Britain and the Netherlands. But poor Europeans still wanted to move there because the country had an almost unlimited supply of land (well, if you were willing to push out a few native Americans) and an acute labour shortage, which meant wages three or four times higher than those in Europe (*see* [Thing 7]). Most importantly, the lack of feudal legacy meant that the country had much higher social mobility than the Old World countries, as celebrated in the idea of the American dream.

It is not just prospective immigrants who are attracted to the US. Especially in the last few decades, businessmen and policy-makers around the world have wanted, and often tried, to emulate the US economic model. Its free enterprise system, according to admirers of the US model, lets people compete without limits and rewards the winners without restrictions imposed by the government or by misguided egalitarian culture. The system therefore creates exceptionally strong incentives for entrepreneurship and innovation. Its free labour market, with easy hiring and firing, allows its enterprises to be agile and thus more competitive, as they can redeploy their workers more quickly than their competitors, in response to changing market conditions. With entrepreneurs richly rewarded and workers having to adapt quickly, the system does create high inequality. However, its proponents argue, even the 'losers' in this game willingly accept such outcomes because, given the country's high social mobility, their own children could be the next Thomas Edison, J. P. Morgan or Bill Gates. With such incentives to work hard and exercise ingenuity, no wonder the country has been the richest in the world for the last century.

Americans just live better …

Actually, this is not quite true. The US is not the richest country in the world any more. Now several European countries have higher per capita incomes. The World Bank data tell us that the per capita income of the US in 2007 was $46,040. There were seven countries with higher per capita income in US dollar terms – starting with Norway ($76,450) at the top, through Luxemburg, Switzerland, Denmark, Iceland, Ireland and ending with Sweden ($46,060). Discounting the two mini-states of Iceland (311,000 people) and Luxemburg (480,000 people), this makes the US only the sixth richest country in the world.

But, some of you may say, that cannot be right. When you go to the US, you just see that people there live better than the Norwegians or the Swiss do.

One reason why we get that impression is that the US is much more unequal than the European countries and therefore looks more prosperous to foreign visitors than it really is – foreign visitors to any country rarely get to see the deprived parts, of which the US has many more than Europe. But even ignoring this inequality factor, there is a good reason why most people think that the US has a higher living standard than European countries.

You may have paid 35 Swiss francs, or $35, for a 5-mile (or 8-km) taxi ride in Geneva, when a similar ride in Boston would have cost you around $15. In Oslo, you may have paid 550 kroner, or $100, for a dinner that could not possibly have been more than $50, or 275 kroner, in St Louis. The reverse would have been the case if you had changed your dollars into Thai baht or Mexican pesos on your holidays. Having your sixth back massage of the week or ordering the third margarita before dinner, you would have felt as if your $100 had been stretched into $200, or even $300 (or was that the alcohol?). If market exchange rates accurately reflected differences in living standards between countries, these kinds of things should not happen.

Why are there such huge differences between the things that you can buy in different countries with what should be the same sums of money? Such differences exist basically because market exchange rates are largely determined by the supply and demand for internationally traded goods and services (although in the short run currency speculation can influence market exchange rates), while what a sum of money can buy in a particular country is determined by the prices of all goods and services, and not just those that are internationally traded.

The most important among the non-traded things are person-to-person labour services, such as driving taxis and serving meals in restaurants. Trade in such services requires international migration, but that is severely limited by immigration control, so the prices of such labour services end up being hugely different across countries (*see Things 3 and 9*). In other words, things such as taxi rides and meals are expensive in countries such as Switzerland and Norway because they have expensive workers. They are cheap in countries with cheap workers, such as Mexico and Thailand. When it comes to internationally traded things such as TVs or mobile phones, their prices are basically the same in all countries, rich and poor.

In order to take into account the differential prices of non-traded goods and services across countries, economists have come up with the idea of an 'international dollar'. Based on the notion of purchasing power parity (PPP) – that is, measuring the value of a currency according to how much of a common consumption basket it can buy in different countries – this fictitious currency allows us to convert incomes of different countries into a common measure of living standards.

The result of converting the incomes of different countries into the international dollar is that the incomes of rich countries tend to become lower than their incomes at market exchange rates, while those of poor countries tend to become higher. This is because a lot of what we consume is services, which are much more expensive in the rich countries. In some cases, the difference between market exchange rate income and PPP income is not great. According to the World Bank data, the market exchange rate income of the US was $46,040 in 2007, while its PPP income was more or less the same at $45,850. In the case of Germany, the difference between the two was greater, at $38,860 vs. $33,820 (a 15 per cent difference, so to speak, although we cannot really compare the two numbers this directly). In the case of Denmark, the difference was nearly 50 per cent ($54,910 vs. $36,740). In contrast, China's 2007 income more than doubles from $2,360 to $5,370 and India's by nearly three times from $950 to $2,740, when calculated in PPP terms.

Now, the calculation of each currency's exchange rate with the (fictitious) international dollar is not a straightforward affair, not least because we have to assume that all countries consume the same basket of goods and services, which is patently not the case. This makes the PPP incomes extremely sensitive to the methodologies and the data used. For example, when the World Bank changed its method of estimating PPP incomes in 2007, China's PPP income per capita fell by 44 per cent (from $7,740 to $5,370), while Singapore's rose by 53 per cent (from $31,710 to $48,520) overnight.

Despite these limits, a country's income in international dollars probably gives us a better idea of its living standard than does its dollar income at the market exchange rate. And if we calculate incomes of different countries in international dollars, the US (almost) comes back to the top of the world. It depends on the estimate, but Luxemburg is the only country that has a higher PPP income per capita than that of the US in all estimates. So, as long as we set aside the tiny city-state of Luxemburg, with less than half a million people, the average US citizen can buy the largest amount of goods and services in the world with her income.

Does this allow us to say that the US has the highest living standard in the world? Perhaps. But there are quite a few things we have to consider before we jump to that conclusion.

… or do they?

To begin with, having a higher *average* income than other countries does not necessarily mean that all US citizens live better than their foreign counterparts. Whether this is the case depends on the distribution of income. Of course, in no country does the average income give the right picture of how people live, but in a country with higher inequality it is likely to be particularly misleading. Given that the US has by far the most unequal distribution of income among the rich countries, we can safely guess that the US per capita income overstates the actual living standards of more of its citizens than in other countries. And this conjecture is indirectly supported by other indicators of living standards. For example, despite having the highest average PPP income, the US ranks only around thirtieth in the world in health statistics such as life expectancy and infant mortality (OK, the inefficiency of the US healthcare system contributes to it, but let's not get into that). The much higher crime rate than in Europe or Japan – in per capita terms, the US has eight times more people in prison than Europe and twelve times more than Japan – shows that there is a far bigger underclass in the US.

Second, the very fact that its PPP income is more or less the same as its market exchange rate income is proof that the higher average living standard in the US is built on the poverty of many. What do I mean by this? As I have pointed out earlier, it is normal for a rich country's PPP income to be lower, sometimes significantly, than its market exchange rate income, because it has expensive service workers. However, this does not happen to the US, because, unlike other rich countries, it has cheap service workers. To begin with, there is a large inflow of low-wage immigrants from poor countries, many of them illegal, which makes them even cheaper. Moreover, even the native workers have much weaker fallback positions in the US than in European countries of comparable income level. Because they have much less job security and weaker welfare supports, US workers, especially the non-unionized ones in the service industries, work for lower wages and under inferior conditions than do their European counterparts. This is why things like taxi rides and meals at restaurants are so much cheaper in the US than in other rich countries. This is great when you are the customer, but not if you are the taxi driver or the waitress. In other words, the higher purchasing power of average US income is bought at the price of lower income and inferior working conditions for many US citizens.

Last but not least, in comparing living standards across countries, we should not ignore the differences in working hours. Even if someone is earning 50 per cent more money than I earn, you wouldn't say that he has a higher living standard than I do, if that person has to work double the number of hours that I do. The same applies to the US. The Americans, befitting their reputation for workaholism, work longer hours than the citizens of any other country that has a per capita income of more than $30,000 at market exchange rate in 2007 (Greece being the poorest of the lot, at just under $30,000 per capita income). Americans work 10 per cent longer than most Europeans and around 30 per cent longer than the Dutch and the Norwegians. According to a calculation by the Icelandic economist Thorvaldur Gylfason, in terms of income (in PPP terms) per hour worked in 2005, the US ranked only eighth – after Luxemburg, Norway, France (yes, France, that nation of loungers), Ireland, Belgium, Austria, and the Netherlands – and was very closely followed by Germany.[1] In other words, per unit of effort, the Americans are not getting as high a living standard as their counterparts in competitor nations. They make up for this lower productivity through much longer hours.

Now, it is perfectly reasonable for someone to argue that she wants to work longer hours if that is necessary to have a higher income – she would rather have another TV than one more week of holiday. And who am I, or anyone else, to say that the person got her priority wrong?

However, it is still legitimate to ask whether people who work longer hours even at very high levels of income are doing the right thing. Most people would agree that, at a low level of income, an increase in income is likely to improve your quality of life, even if it means longer working hours. At this level, even if you have to work longer in your factory, higher income is likely to bring a higher overall quality of life, by improving your health (through better food, heating, hygiene and healthcare) and by reducing the physical demands of household work (through more household appliances, piped water, gas and electricity – *see* *Thing 4*). However, above a certain level of income, the relative value of material consumption *vis-à-vis* leisure time is diminished, so earning a higher income at the cost of working longer hours may reduce the quality of your life.

More importantly, the fact that the citizens of a country work longer than others in comparable countries does not necessarily mean that they *like* working longer hours. They may be compelled to work long hours, even if they actually want to take longer holidays. As I pointed out above, how long a person works is affected not only by his own preference regarding work – leisure balance but also by things such as welfare provision, protection of worker rights and union power. Individuals have to take these things as given, but nations have a choice over them. They can rewrite the labour laws, beef up the welfare state and effect other policy changes to make it less necessary for individuals to work long hours.

Much of the support for the American model has been based on the ‘fact’ that the US has the highest living standard in the world. While there is no question that the US has one of the highest living standards in the world, its alleged superiority looks much weaker once we have a broader conception of living standards than what the average income of a country will buy. Higher inequality in the US means that its average income is less indicative of the living standards of its citizens than in other countries. This is reflected in indicators such as health and crime, where the US performs much worse than comparable countries. The higher purchasing power of US citizens (compared to the citizens of other rich countries) is owed in large part to the poverty and insecurity of many of their fellow citizens, especially in service industries. The Americans also work considerably longer than their counterparts in competitor nations. Per hour worked, US income is lower than that of several European countries, even in purchasing power terms. It is debatable that that can be described as having a higher living standard.

There is no simple way to compare living standards across countries. Per capita income, especially in purchasing power terms, is arguably the most reliable indicator. However, by focusing just on how many goods and services our income can buy, we miss out a lot of other things that constitute elements of the ‘good life’, such as the amount of quality leisure time, job security, freedom from crime, access to healthcare, social welfare provisions, and so on. While different individuals and countries will definitely have different views on how to weigh these indicators against each other and against income figures, non-income dimensions should not be ignored, if we are to build societies where people genuinely ‘live well’.

Thing 11

Africa is not destined for underdevelopment

What they tell you

Africa is destined for underdevelopment. It has a poor climate, which leads to serious tropical disease problems. It has lousy geography, with many of its countries landlocked and surrounded by countries whose small markets offer limited export opportunities and whose violent conflicts spill into neighbouring countries. It has too many natural resources, which make its people lazy, corrupt and conflict-prone. African nations are ethnically divided, which renders them difficult to manage and more likely to experience violent conflicts. They have poor-quality institutions that do not protect investors well. Their culture is bad – people do not work hard, they do not save and they cannot cooperate with each other. All these structural handicaps explain why, unlike other regions of the world, the continent has failed to grow even after it has implemented significant market liberalization since the 1980s. There is no other way forward for Africa than being propped up by foreign aid.

What they don't tell you

Africa has *not* always been stagnant. In the 1960s and 70s, when all the supposed structural impediments to growth were present and often more binding, it actually posted a decent growth performance. Moreover, all the structural handicaps that are supposed to hold back Africa have been present in most of today's rich countries – poor climate (arctic and tropical), landlockedness, abundant natural resources, ethnic divisions, poor institutions and bad culture. These structural conditions seem to act as impediments to development in Africa only because its countries do not yet have the necessary technologies, institutions and organizational skills to deal with their adverse consequences. The real cause of African stagnation in the last three decades is free-market policies that the continent has been compelled to implement during the period. Unlike history or geography, policies can be changed. Africa is not destined for underdevelopment.

The world according to Sarah Palin … or was it **The Rescuers***?*

Sarah Palin, the Republican vice-presidential candidate in the 2008 US election, is reported to have thought that Africa was a country, rather than a continent. A lot of people wondered where she got that idea, but I think I know the answer. It was from the 1977 Disney animation *The Rescuers*.

The Rescuers is about a group of mice called the Rescue Aid Society going around the world, helping animals in trouble. In one scene, there is an international congress of the society, with mouse delegates from all sorts of countries in their traditional costumes and appropriate accents (if they happen to speak). There is the French mouse in his beret, the German mouse in her sombre blue dress and the

Turkish mouse in his fez. And then there is the mouse in his fur hat and beard representing Latvia and the female mouse representing, well, Africa.

Perhaps Disney didn't literally think that Africa was a country, but allocating one delegate each to a country with 2.2 million people and to a continent of more than 900 million people and nearly sixty countries (the exact number depends on whether you recognize entities such as Somaliland and Western Sahara as countries) tells you something about its view of Africa. Like Disney, many people see Africa as an amorphous mass of countries suffering from the same hot weather, tropical diseases, grinding poverty, civil war and corruption.

While we should be careful not to lump all African countries together, there is no denying that most African countries are very poor – especially if we confine our interest to Sub-Saharan Africa (or 'black' Africa), which is really what most people mean when they say Africa. According to the World Bank, the average per capita income of Sub-Saharan Africa was estimated to be $952 in 2007. This is somewhat higher than the $880 of South Asia (Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka), but lower than that of any other region of the world.

What is more, many people talk of Africa's 'growth tragedy'. Unlike South Asia, whose growth rates have picked up since the 1980s, Africa seems to be suffering from 'a chronic failure of economic growth'.[1] Sub-Saharan Africa's per capita income today is more or less the same as what it was in 1980. Even more worrying is the fact that this lack of growth seems to be due not mainly to poor policy choices (after all, like many other developing countries, countries in the region have implemented free-market reforms since the 1980s) but mainly to the handicaps handed down to them by nature and history and thus extremely difficult, if not impossible, to change.

The list of supposed 'structural' handicaps that are holding Africa back is impressive.

First, there are all those conditions defined by nature – climate, geography and natural resources. Being too close to the equator, it has rampant tropical diseases, such as malaria, which reduce worker productivity and raise healthcare costs. Being landlocked, many African countries find it difficult to integrate into the global economy. They are in 'bad neighbourhoods' in the sense that they are surrounded by other poor countries that have small markets (which restrict their trading opportunities) and, frequently, violent conflicts (which often spill over into neighbouring countries). African countries are also supposed to be 'cursed' by their abundant natural resources. It is said that resource abundance makes Africans lazy – because they 'can lie beneath a coconut tree and wait for the coconut to fall', as a popular expression of this idea goes (although those who say that obviously have not tried it; you risk having your head smashed). 'Unearned' resource wealth is also supposed to encourage corruption and violent conflicts over the spoils. The economic successes of resource-poor East Asian countries, such as Japan and Korea, are often cited as cases of 'reverse resource curse'.

Not just nature but Africa's history is also supposed to be holding it back. African nations are ethnically too diverse, which causes people to be distrustful of each other and thus makes market transactions costly. It is argued that ethnic diversity may encourage violent conflicts, especially if there are a few equally strong groups (rather than many small groups, which are more difficult to organize). The history of colonialism is thought to have produced low-quality institutions in most African countries, as the colonizers did not want to settle in countries with too many tropical diseases (so there is an interaction between climate and institutions) and thus installed only the minimal institutions needed for resource extraction, rather than for the development of the local economy. Some even venture that African culture is bad for economic development – Africans do not work hard, do not plan for the future and cannot cooperate with each other.[2]

Given all this, Africa's future prospects seem bleak. For some of these structural handicaps, any solution seems unachievable or unacceptable. If being landlocked, being too close to the equator and sitting in a bad neighbourhood are holding Uganda back, what should it do? Physically moving a country is not an option, so the only feasible answer is colonialism – that is, Uganda should invade, say, Norway, and move all the Norwegians to Uganda. If having too many ethnic groups is bad for development, should Tanzania, which has one of the greatest ethnic diversities in the world, indulge in a spot of ethnic cleansing? If having too many natural resources hampers growth, should the Democratic Republic of Congo try to sell the portions of its land with mineral deposits to, say, Taiwan so that it can pass on the natural resource curse to someone else? What should Mozambique do if its colonial history has left it with bad institutions? Should it invent a time machine and fix that history? If Cameroon has a culture that is bad for economic development, should it start some mass brain-washing programme or put people in some re-education camp, as the Khmer Rouge did in Cambodia?

All of these policy conclusions are either physically impossible (moving a country, inventing a time machine) or politically and morally unacceptable (invasion of another country, ethnic cleansing, re-education camps). Therefore, those who believe in the power of these structural handicaps but find these extreme solutions unacceptable argue that African countries should be put on some kind of permanent 'disability benefit' through foreign aid and extra help with international trade (e.g., rich countries lowering their agricultural protection only for African – and other similarly poor and structurally disadvantaged – countries).

But is there any other way for Africa's future development beyond accepting its fate or relying on outside help? Do African countries have no hope of standing on their own feet?

An African growth tragedy?

One question that we need to ask before we try to explain Africa's growth tragedy and explore possible ways to overcome it is whether there is indeed such a tragedy. And the answer is 'no'. The lack of growth in the region has *not* been chronic.

During the 1960s and 70s, per capita income in Sub-Saharan Africa grew at a respectable rate. At around 1.6 per cent, it was nowhere near the 'miracle' growth rate of East Asia (5–6 per cent) or even that of Latin America (around 3 per cent) during the period. However, this is not a growth rate to be sniffed at. It compares favourably with the rates of 1–1.5 per cent achieved by today's rich countries during their Industrial 'Revolution' (roughly 1820–1913).

The fact that Africa grew at a respectable rate before the 1980s suggests that the 'structural' factors cannot be the main explanation of the region's (what in fact is recent) growth failure. If they were, African growth should always have been non-existent. It is not as if the African countries suddenly moved to the tropics or some seismic activity suddenly made some of them landlocked. If the structural factors were so crucial, African economic growth should have accelerated over time, as at least some of those factors would have been weakened or eliminated. For example, poor-quality institutions left behind by the colonists could have been abandoned or improved. Even ethnic diversity could have been reduced through compulsory education, military service and mass media, in the same way in which France managed to turn 'peasants into Frenchmen', as the title of a classic 1976 book by the American historian Eugen Weber goes.[3] However, this is not what has happened – African growth suddenly collapsed since the 1980s.

So, if the structural factors have always been there and if their influences would have, if anything, diminished over time, those factors cannot explain why Africa used to grow at a decent rate in the 1960s and 70s and then suddenly failed to grow. The sudden collapse in growth must be explained by something that happened around 1980. The prime suspect is the dramatic change in policy direction around the time.

Since the late 1970s (starting with Senegal in 1979), Sub-Saharan African countries were forced to adopt free-market, free-trade policies through the conditions imposed by the so-called Structural Adjustment Programs (SAPs) of the World Bank and the IMF (and the rich countries that ultimately control them). Contrary to conventional wisdom, these policies are *not* good for economic development (*see* *Thing 7*). By suddenly exposing immature producers to international competition, these policies led to the collapse of what little industrial sectors these countries had managed to build up during the 1960s and 70s. Thus, having been forced back into relying on exports of primary commodities, such as cocoa, coffee and copper, African countries have continued to suffer from the wild price fluctuations and stagnant production technologies that characterize most such commodities. Furthermore, when the SAPs demanded a rapid increase in exports, African countries, with technological capabilities only in a limited range of activities, ended up trying to export similar things – be they traditional products such as coffee and cocoa or new products such as cut flowers. The result was often a collapse of prices in those commodities due to a large increase in their supplies, which sometimes meant that these countries were exporting more in quantity but earning less in revenue. The pressure on governments to balance their budgets led to cuts in expenditures whose impacts are slow to show, such as infrastructure. Over time, however, the deteriorating quality of infrastructure disadvantaged African producers even more, making their ‘geographical disadvantages’ loom even larger.

The result of the SAPs – and their various later incarnations, including today’s PRSPs (Poverty Reduction Strategy Papers) – was a stagnant economy that has failed to grow (in per capita terms) for three decades. During the 1980s and 90s, per capita income in Sub-Saharan Africa *fell* at the rate of 0.7 per cent per year. The region finally started to grow in the 2000s, but the contraction of the preceding two decades meant that the average annual growth rate of per capita income in Sub-Saharan Africa between 1980 and 2009 was 0.2 per cent. So, after nearly thirty years of using ‘better’ (that is, free-market) policies, its per capita income is basically at the same level as it was in 1980.

So, the so-called structural factors are really scapegoats wheeled out by free-market economists. Seeing their favoured policies failing to produce good outcomes, they had to find other explanations for Africa’s stagnation (or retrogression, if you don’t count the last few years of growth spike due to commodity boom, which has come to an end). It was unthinkable for them that such ‘correct’ policies could fail. It is no coincidence that structural factors came to be cited as the main explanations of poor African economic performance *only after* growth evaporated in the early 1980s.

Can Africa change its geography and history?

Pointing out that the above-mentioned structural variables were invoked in an attempt to save free-market economics from embarrassment does not mean that they are irrelevant.

Many of the theories offered as to how a particular structural variable affects economic outcome do make sense. Poor climate can hamper development. Being surrounded by poor and conflict-ridden countries limits export opportunities and makes cross-border spill-over of conflicts more likely. Ethnic diversity or resource bonanzas can generate perverse political dynamics. However, these outcomes are not inevitable.

To begin with, there are many different ways in which those structural factors can play out. For example, abundant natural resources can create perverse outcomes, but can also promote development. If that weren't the case, we wouldn't consider the poor performances of resource-rich countries to be perverse in the first place. Natural resources allow poor countries to earn the foreign exchanges with which they can buy advanced technologies. Saying that those resources are a curse is like saying that all children born into a rich family will fail in life because they will get spoilt by their inherited wealth. Some do so exactly for this reason, but there are many others who take advantage of their inheritance and become even more successful than their parents. The fact that a factor is structural (that is, it is given by nature or history) does not mean that the outcome of its influence is predetermined.

Indeed, the fact that all those structural handicaps are not insurmountable is proven by the fact that most of today's rich countries have developed despite suffering from similar handicaps.[4]

Let us first take the case of the climate. Tropical climate is supposed to cripple economic growth by creating health burdens due to tropical diseases, especially malaria. This is a terrible problem, but surmountable. Many of today's rich countries used to have malaria and other tropical diseases, at least during the summer – not just Singapore, which is bang in the middle of the tropics, but also Southern Italy, the Southern US, South Korea and Japan. These diseases do not matter very much any more only because these countries have better sanitation (which has vastly reduced their incidence) and better medical facilities, thanks to economic development. A more serious criticism of the climate argument is that frigid and arctic climates, which affect a number of rich countries, such as Finland, Sweden, Norway, Canada and parts of the US, impose burdens as economically costly as tropical ones – machines seize up, fuel costs skyrocket, and transportation is blocked by snow and ice. There is no *a priori* reason to believe that cold weather is better than hot weather for economic development. The cold climate does not hold those countries back because they have the money and the technologies to deal with them (the same can be said of Singapore's tropical climate). So blaming Africa's underdevelopment on climate is confusing the cause of underdevelopment with its symptoms – poor climate does not cause underdevelopment; a country's inability to overcome its poor climate is merely a symptom of underdevelopment.

In terms of geography, the landlocked status of many African countries has been much emphasized. But then what about Switzerland and Austria? These are two of the richest economies in the world, and they are landlocked. The reader may respond by saying that these countries could develop because they had good river transport, but many landlocked African countries are potentially in the same position: e.g., Burkina Faso (the Volta), Mali and Niger (the Niger), Zimbabwe (the Limpopo) and Zambia (the Zambezi). So it is the lack of investment in the river transport system, rather than the geography itself, that is the problem. Moreover, due to freezing seas in winter, Scandinavian countries used to be effectively landlocked for half of the year, until they developed the ice-breaking ship in the late nineteenth century. A bad neighbourhood effect may exist, but it need not be binding – look at the recent rapid growth of India, which is located in the poorest region in the world (poorer than Sub-Saharan Africa, as mentioned above), which also has its share of conflicts (the long history of military conflicts between India and Pakistan, the Maoist Naxalite guerrillas in India, the Tamil–Sinhalese civil war in Sri Lanka).

Many people talk of the resource curse, but the development of countries such as the US, Canada and Australia, which are much better endowed with natural resources than all African countries, with the possible exceptions of South Africa and the DRC (Democratic Republic of Congo), show that abundant resources can be a blessing. In fact, most African countries are not that well endowed with natural resources – fewer than a dozen African countries have so far discovered any significant mineral deposits.[5] Most African countries may be abundantly endowed with natural resources in relative terms, but that is only because they have so few man-made resources, such as machines, infrastructure, and skilled labour. Moreover, in the late nineteenth and early twentieth centuries, the fastest-growing regions of the world were resource-rich areas such as North America, Latin America and Scandinavia, suggesting that the resource curse has not always existed.

Ethnic divisions can hamper growth in various ways, but their influence should not be exaggerated. Ethnic diversity is the norm elsewhere too. Even ignoring ethnic diversities in immigration-based societies such as the US, Canada and Australia, many of today's rich countries in Europe have suffered from linguistic, religious and ideological divides – especially of the 'medium-degree' (a few, rather than numerous, groups) that is supposed to be most conducive to violent conflicts. Belgium has two (and a bit, if you count the tiny German-speaking minority) ethnic groups. Switzerland has four languages and two religions, and has experienced a number of mainly religion-based civil wars. Spain has serious minority problems with the Catalans and the Basques, which have even involved terrorism. Due to its 560-year rule over Finland (1249 to 1809, when it was ceded to Russia), Sweden has a significant Finnish minority (around 5 per cent of the population) and Finland a Swedish one of similar scale. And so on.

Even East Asian countries that are supposed to have particularly benefited from their ethnic homogeneity have serious problems with internal divisions. You may think Taiwan is ethnically homogeneous as its citizens are all 'Chinese', but the population consists of two (or four, if you divide them up more finely) linguistic groups (the 'mainlanders' vs. the Taiwanese) that are hostile to each other. Japan has serious minority problems with the Koreans, the Okinawans, the Ainus and the Burakumins. South Korea may be one of the most ethno-linguistically homogeneous countries in the world, but that has not prevented my fellow countrymen from hating each other. For example, there are two regions in South Korea that particularly hate each other (Southeast and Southwest), so much so that some people from those regions would not allow their children to get married to someone from 'the other place'. Very interestingly, Rwanda is nearly as homogeneous in ethno-linguistic terms as Korea, but that did not prevent the ethnic cleansing of the formerly dominant minority Tutsis by the majority Hutus – an example that proves that 'ethnicity' is a political, rather than a natural, construction. In other words, rich countries do not suffer from ethnic heterogeneity not because they do not have it but because they have succeeded in nation-building (which, we should note, was often an unpleasant and even violent process).

People say that bad institutions are holding back Africa (and they are), but when the rich countries were at similar levels of material development to those we find in Africa currently, their institutions were in a far worse state.[6] Despite that, they grew continuously and have reached high levels of development. They built the good institutions largely after, or at least in tandem with, their economic development. This shows that institutional quality is as much an outcome as the causal factor of economic development. Given this, bad institutions cannot be the explanation of growth failure in Africa.

People talk about 'bad' cultures in Africa, but most of today's rich countries had once been argued to have comparably bad cultures, as I documented in the chapter 'Lazy Japanese and thieving Germans' in my earlier book *Bad Samaritans*. Until the early twentieth century, Australians and Americans would go to Japan and say the Japanese were lazy. Until the mid nineteenth century, the British would go to Germany and say that the Germans were too stupid, too individualistic and too emotional to develop their economies (Germany was not unified then) – the exact opposite of the stereotypical image that they have of the Germans today and exactly the sort of things that people now say about Africans. The Japanese and German cultures were transformed with economic development, as the demands of a highly organized industrial society made people behave in more disciplined, calculating and cooperative ways. In that sense, culture is more of an outcome, rather than a cause, of economic development. It is wrong to blame Africa's (or any region's or any country's) underdevelopment on its culture.

Thus seen, what appear to be unalterable structural impediments to economic development in Africa (and indeed elsewhere) are usually things that can be, and have been, overcome with better technologies, superior organizational skills and improved political institutions. The fact that most of today's rich countries themselves used to suffer (and still suffer to an extent) from these conditions is an indirect proof of this point. Moreover, despite having these impediments (often in more severe forms), African countries themselves did not have a problem growing in the 1960s and 70s. The main reason for Africa's recent growth failure lies in policy – namely, the free-trade, free-market policy that has been imposed on the continent through the SAP. Nature and history do not condemn a country to a particular future. If it is policy that is causing the problem, the future can be changed even more easily. The fact that we have failed to see this, and not its allegedly chronic growth failure, is the real tragedy of Africa.