To Become a Rich Country: Industrialization Policy First, Free Trade Second , November 12, 2007
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This review is from: How Rich Countries Got Rich ... and Why Poor Countries Stay Poor (Hardcover)
Erik Reinert masterfully uses experienced-based economics to demonstrate how rich countries got rich. Economic growth and welfare in rich countries originated not in unrestrained international free trade, but in conscious and deliberate industrialization policy that progressively shaped a particular form of economic structure (pp. xx, xxiv, 9-10, 47-48, 65, 79-83, 88, 98-100, 115-20, 177, 198, 246-49, 288-89).

Reinert's greatest merit is to clearly show how economic development really works (pp. 39, 52, 305-08):

1) A country first industrializes behind a wall of tariffs, direct subsidies, and/or patents and is then slowly and systematically integrated economically with nations at the same level of development (pp. 17, 22-24, 56, 84, 88, 134, 171, 210, 235, 268-69, 273). The United States followed the example of England to industrialize behind a protectionist wall for about 150 years based on Adam Smith's Wealth of Nations (pp. 23-25, 31, 58, 212). The Marshall Plan to reindustrialize Europe after WWII was built on the same logic (pp. 63, 89-90, 179-81, 241, 265-66).

Countries already wealthy need very different economic policies from those of countries still poor (p. 81). An aspiring poor country needs to tax "bad" trade, i.e., exports of raw materials (read agricultural or mining products) and imports of industrial products (pp. 17, 21, 62, 78). Perfect or commodity competition is for the poor, resulting in price-driven diminishing returns, no industrialization, and immigration to the rich world (pp. 8, 18, 62, 71, 133, 149-201, 245, 280-81). Unlike development economics, palliative economics do not radically change the productive structures of poor countries but instead focus on easing the pains of economic misery (pp. 63, 179, 211, 239-70, 282, 296-97).

Paradoxically, being poor in natural resources is one of the keys to becoming rich (pp. 7, 77). A poor country has to encourage "good" trade, i.e., imports of raw products and exports of industrial products. The existence of an (inefficient) manufacturing sector establishes a national wage level which prevents countries from moving too far into diminishing returns (pp. 109, 124, 183, 251, 265, 295). Reinert observes that "good" trade also results from the export of industrial goods in exchange for other industrial goods (p. 89).

That initial protection is essential to achieve increasing returns and to access new technologies (p. 67). Once these goals are achieved, further protectionism is counterproductive. Reinert contrasts the "good" protectionism of East Asia with the "bad" protectionism of Latin America (pp. 224, 285, 311-12). Solidly industrialized countries require bigger and more international markets to further develop and prosper (p. 81).

The timing of the opening up of an economy to international competition is therefore critical. Opening up too late undermines growth (p. 205). In contrast, opening up prematurely will result in deindustrialization, falling wages, and increasing social problems (p. 252). Mongolia and Peru are two examples that come to mind (pp. 110, 164, 173-79, 251-52). That insight about the timing of free trade is absent in the Washington Consensus as applied to most of the developing world (pp. 19, 55, 68-69, 81, 84, 107, 204, 216-37, 244, 278, 295).

2) The preconditions for wealth, democracy, and political freedom are diversified manufacturing

and knowledge-intensive services subject to increasing returns (pp. 268-69). In some economic activities (read manufacturing and advanced services), costs fall as the volume of production increases (pp. 36, 38, 108-09).

David Ricardo's theory of comparative advantage in international trade relies on a number of simplistic, abstract assumptions that too often lock poor countries into specializing in being poor (pp. 15, 23, 42, 59, 75, 106, 277, 301-04, 309-10). One of the key assumptions is that there are no qualitative differences between economic activities. If left alone, the market will even out the differences between say, Microsoft in the U.S. and goat-herders in Mongolia (p. 177). Ricardo's theory is also built on the rigid assumption that there can be no change in specialization, which unsurprisingly results in factor-price polarization (pp. 19, 117, 213-14).

3) Economic wealth results from synergies, i.e., people of many different trades and professions sharing a community (pp. 73, 93-95, 102, 136, 268-69, 275). The diversity of economic activities based on the extent of division of labor makes it possible for new knowledge to be transferred from one sector to the other (pp. 94-95, 256-63, 276). Ricardo's theory completely ignores synergies (p. 214).

Reinert clearly explains to his audience that this path for a country to join the club of rich countries is much more difficult today than in the past for the following reasons (pp. 290, 292-93):

1) Information Technology: Unlike process innovations, product innovation tends to create imperfect competition and higher wages. For example, at Google, search technology as a product innovation results in high wages and high profits. When the same technology is employed in say, the hotel and airline industries, the results are falling margins for the travel industry and lower wages for many persons employed in that sector of activity (pp. 188, 229).

2) Intellectual Property: The increasing percentage of copyrighted, trademarked, and patented products widens the gap between rich and poor countries (pp. 111-14). For example, the pharmaceutical industry based in rich countries works hard to legally protect the output of its substantial investment in research and development.

3) Workers Distribution: There is a transition from single-plant economies of scale towards multi-location economies of scope. For example, the integrated American automakers are evolving toward modular architectures for their mainstream models to compete on speed and flexibility.

4) Workforce Mix: Manufacturing increasingly gets automated while services occupy an increasing percentage of the total workforce.

5) Workers Substitution: Service workers are often more easily substituted than specialized industrial workers, resulting in diminished workers' bargaining power.

6) Employers Fragmentation: Decentralized franchising instead of centralized ownership also reduces workers' power at the negotiation table.

To summarize, Reinert recommends that poor countries study the policies of those who created American and European prosperity, and ignore the advice of their forgetful successors (pp. xxix, 13). "Do not do as the Americans tell you to do, do as the Americans did," concludes Reinert (pp. 23, 168).