With irreverent wit, an engagingly personal style, and a battery of examples, Chang blasts holes in the "World Is Flat" orthodoxy of Thomas Friedman and other liberal economists who argue that only unfettered capitalism and wide-open international trade can lift struggling nations out of poverty. On the contrary, Chang shows, today's economic superpowers—from the U.S. to Britain to his native South Korea—all attained prosperity by shameless protectionism and government intervention in industry. We have conveniently forgotten this fact, telling ourselves a fairy tale about the magic of free trade while we cram policies that suit ourselves down the throat of the developing world. This pungently contrarian history demolishes one pillar after another of free-market mythology.

"A well-researched and readable case against free-trade orthodoxy."
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"This is a marvelous book. Well researched, panoramic in its scope, and beautifully written, *Bad Samaritans* is the perfect riposte to devotees of a one-size-fits-all model of growth and globalization. I strongly urge you to read it."
—LARRY ELLIOTT, economics editor, *Guardian*

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—PAUL BLUSTEIN, *Washington Post*

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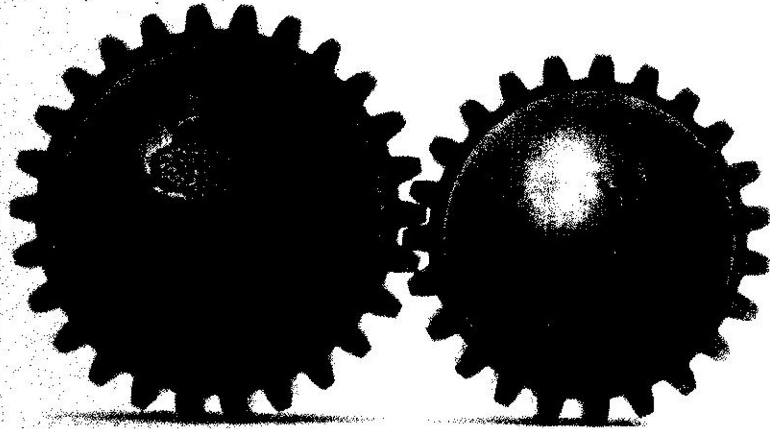
BAD SAMARITAN



THE MYTH O
FREE TRA
AND THE SECRET HISTO
CAPITAL

CHANG

propaganda machine, a financial-intellectual complex backed by money and power.

This neo-liberal establishment would have us believe that, during its miracle years between the 1960s and the 1980s, Korea pursued a neo-liberal economic development strategy.[7] The reality, however, was very different indeed. What Korea actually did during these decades was to nurture certain new industries, selected by the government in consultation with the private sector, through tariff protection, subsidies and other forms of government support (e.g., overseas marketing information services provided by the state export agency) until they 'grew up' enough to withstand international competition. The government owned all the banks, so it could direct the life blood of business – credit. Some big projects were undertaken directly by state-owned enterprises – the steel maker, POSCO, being the best example – although the country had a pragmatic, rather than ideological, attitude to the issue of state ownership. If private enterprises worked well, that was fine; if they did not invest in important areas, the government had no qualms about setting up state-owned enterprises (SOEs); and if some private enterprises were mismanaged, the government often took them over, restructured them, and usually (but not always) sold them off again.

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

The popular impression of Korea as a free-trade economy was created by its export success. But export success does not require free trade, as Japan and China have also shown. Korean exports in the earlier period – things like simple garments and cheap electronics – were all means

to earn the hard currencies needed to pay for the advanced technologies and expensive machines that were necessary for the new, more difficult industries, which were protected through tariffs and subsidies. At the same time, tariff protection and subsidies were not there to shield industries from international competition forever, but to give them the time to absorb new technologies and establish new organizational capabilities until they could compete in the world market.

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

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

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

Why then don't the rich countries recommend to today's developing countries the strategies that served them so well? Why do they instead hand out a fiction about the history of capitalism, and a bad one at that?

The Lexus and the olive tree revisited

Myths and facts about globalization

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

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

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

Others disagreed. They argued that no country had got anywhere without developing 'serious' industries like automobile production.

They just needed more time to make cars that appealed to everyone.

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

Half a century after the Toyopet debacle, Toyota's luxury brand Lexus has become something of an icon for globalization, thanks to the American journalist Thomas Friedman's book, *The Lexus and the Olive Tree*. The book owes its title to an epiphany that Friedman had on the Shinkansen bullet train during his trip to Japan in 1992. He had paid a visit to a Lexus factory, which mightily impressed him. On his train back from the car factory in Toyota City to Tokyo, he came across yet another newspaper article about the troubles in the Middle East where he had been a long-time correspondent. Then it hit him. He realized that that 'half the world seemed to be . . . intent on building a better Lexus, dedicated to modernizing, streamlining, and privatizing their economies in order to thrive in the system of globalization. And half of the world – sometimes half the same country, sometimes half the same person – was still caught up in the fight over who owns which olive tree'.[1]

According to Friedman, unless they fit themselves into a particular set of economic policies that he calls the Golden Straitjacket, countries in the olive-tree world will not be able to join the Lexus world. In describing the Golden Straitjacket, he pretty much sums up today's neo-liberal economic orthodoxy: in order to fit into it, a country needs to privatize state-owned enterprises, maintain low inflation, reduce the size of government bureaucracy, balance the budget (if not running a surplus), liberalize trade, deregulate foreign investment, deregulate capital markets, make the currency convertible, reduce corruption and privatize pensions.[2] According to him, this is the only path to success in the new global economy. His Straitjacket

is the only gear suitable for the harsh but exhilarating game of globalization. Friedman is categorical: 'Unfortunately, this Golden Straitjacket is pretty much "one-size fits all" . . . It is not always pretty or gentle or comfortable. But it's here and it's the only model on the rack this historical season.'[3]

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

The official history of globalization

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

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

and labour; and macroeconomic stability, both nationally and internationally, guaranteed by the principles of sound money (low inflation) and balanced budgets. A period of unprecedented prosperity followed.

Unfortunately, things started to go wrong after the First World War. In response to the ensuing instability of the world economy, countries unwisely began to erect trade barriers again. In 1930, the US abandoned free trade and enacted the infamous Smoot-Hawley tariff. Countries like Germany and Japan abandoned liberal policies and erected high trade barriers and created cartels, which were intimately associated with their fascism and external aggression. The world free trade system finally ended in 1932, when Britain, hitherto the champion of free trade, succumbed to temptation and itself re-introduced tariffs. The resulting contraction and instability in the world economy, and then, finally, the Second World War, destroyed the last remnants of the first liberal world order.

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

Fortunately, illiberal policies have been largely abandoned across the world since the 1980s following the rise of neo-liberalism. By the late 1970s, the failures of so-called import substitution industrialization (ISI) in developing countries – based on protection, subsidies and regulation – had become too obvious to ignore.* The economic 'miracle' in

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

East Asia, which was already practising free trade and welcoming foreign investment, was a wake-up call for the other developing countries. After the 1982 Third World debt crisis, many developing countries abandoned interventionism and protectionism, and embraced neo-liberalism. The crowning glory of this trend towards global integration was the fall of communism in 1989.

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

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

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

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

The real history of globalization

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

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

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

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

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

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

Neo-liberals vs neo-idiotics?

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

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

But more misleading is the portrayal of the experiences of developing countries. The postwar period is described by the official historians of globalization as an era of economic disasters in these countries. This was because, they argue, these countries believed in 'wrong' economic theories that made them think they could defy

market logic. As a result, they suppressed activities which they were good at (agriculture, mineral extraction and labour-intensive manufacturing) and promoted 'white elephant' projects that made them feel proud but were economic nonsense – the most notorious example of this is Indonesia producing heavily subsidized jet aeroplanes.

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

The problem with this interpretation is that the 'bad old days' in the developing countries weren't so bad at all. During the 1960s and the 1970s, when they were pursuing the 'wrong' policies of protectionism and state intervention, *per capita* income in the developing countries grew by 3.0% annually.[18] As my esteemed colleague Professor Ajit Singh once pointed out, this was the period of 'Industrial Revolution in the Third World'.[19] This growth rate is a huge improvement over what they achieved under free trade during the 'age of imperialism' (see above) and compares favourably with the 1–1.5% achieved by the rich countries during the Industrial Revolution in the 19th century. It also remains the best that they have ever recorded. Since the 1980s, after they implemented neo-liberal policies, they grew at only about half the speed seen in the 1960s and the 1970s (1.7%). Growth slowed down in the rich countries too, but the slowdown was less marked (from 3.2% to 2.1%), not least because they did not introduce neo-liberal policies to the same extent as the developing countries did. The average growth rate of developing countries in this period would be even lower if we exclude China and India. These two countries, which accounted for 12% of total developing country income in 1980 and 30% in 2000, have so far refused to put on Thomas Friedman's Golden Straitjacket.[20]

Growth failure has been particularly noticeable in Latin America and Africa, where neo-liberal programmes were implemented more

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

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

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

The distortion of facts in the official history of globalization is also evident at country level. Contrary to what the orthodoxy would have us believe, virtually all the successful developing countries since the

Second World War initially succeeded through nationalistic policies, using protection, subsidies and other forms of government intervention.

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

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

The more recent economic success stories of China, and increasingly India, are also examples that show the importance of strategic, rather than unconditional, integration with the global economy based on a nationalistic vision. Like the US in the mid-19th century, or Japan and Korea in the mid-20th century, China used high tariffs to build up its industrial base. Right up to the 1990s, China's average tariff was

over 30%. Admittedly, it has been more welcoming to foreign investment than Japan or Korea were. But it still imposed foreign ownership ceilings and local contents requirements (the requirements that the foreign firms buy at least a certain proportion of their inputs from local suppliers).

India's recent economic success is often attributed by the pro-globalizers to its trade and financial liberalization in the early 1990s. As some recent research reveals, however, India's growth acceleration really began in the 1980s, discrediting the simple 'greater openness accelerates growth' story.[23] Moreover, even after the early 1990s trade liberalization, India's average manufacturing tariffs remained at above 30% (it is still 25% today). India's protectionism before the 1990s was certainly over-done in some sectors. But this is not to say that India would have been even more successful had it adopted free trade at independence in 1947. India has also imposed severe restrictions on foreign direct investment – entry restrictions, ownership restrictions and various performance requirements (e.g., local contents requirements).

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

Chile's early experiment with neo-liberalism, led by the so-called Chicago Boys (a group of Chilean economists trained at the University of Chicago, one of the centres of neo-liberal economics), was a disaster. It ended in a terrible financial crash in 1982, which had to be resolved by the nationalization of the whole banking sector. Thanks to this crash, the country recovered the pre-Pinochet level of income only in the late 1980s.[25] It was only when Chile's neo-liberalism got more pragmatic after the crash that the country started doing well. For example, the government provided exporters with a lot of help in overseas marketing and R&D.[26] It also used capital controls in the 1990s to successfully

reduce the inflow of short-term speculative funds, although its recent free trade agreement with the US has forced it to promise never to use them again. More importantly, there is a lot of doubt about the sustainability of Chile's development. Over the past three decades, the country has lost a lot of manufacturing industries and become excessively dependent on natural-resources-based exports. Not having the technological capabilities to move into higher-productivity activities, Chile faces a clear limit to the level of prosperity it can attain in the long run.

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

Who's running the world economy?

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

But more important than their sheer weight is the rich countries' willingness to throw that very weight about in shaping the rules of the global economy. For example, developed countries induce poorer countries to adopt particular policies by making them a condition for their foreign aid or by offering them preferential trade agreements in return for 'good behaviour' (adoption of neo-liberal policies). Even more important in shaping options for developing countries, however, are the actions of multilateral organizations such as the 'Unholy Trinity'

– namely the IMF, the World Bank and the WTO (World Trade Organisation). Though they are not puppets of the rich countries, the Unholy Trinity are largely controlled by the rich countries, so they devise and implement Bad Samaritan policies that those countries want.

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

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

This mission creep raises a serious issue. The World Bank and the IMF initially started with rather limited mandates. Subsequently, they

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

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

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

In the beginning, the IMF only imposed conditions closely related to the borrower country's management of its balance of payments, such as currency devaluation. But then it started putting conditions on government budgets on the grounds that budget deficits are a key

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

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

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

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

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

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

The IMF and the World Bank have also tried to increase the 'local ownership' of their programmes by involving local people in their design. However, this has borne few fruits. Many developing countries lack the intellectual resources to argue against powerful international organizations with an army of highly trained economists and a lot of financial clout behind them. Moreover, the World Bank and the IMF have taken

what I call the 'Henry Ford approach to diversity' (he famously said that customers could have a car painted 'any colour so long as it's black'). The range of local variation in policies that they find acceptable is very narrow. Also, with the increasing tendency for developing countries to elect or appoint ex-World Bank or ex-IMF officials to key economic posts, 'local' solutions are increasingly resembling the solutions provided by the Bretton Woods Institutions.

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

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

But, despite these criticisms, the World Trade Organisation is an international organization in whose running the developing countries have the greatest say. Unlike the IMF or the World Bank, it is 'democratic' – in the sense of allowing one country one vote (of course, we can debate whether giving China, with 1.3 billion people, and Luxembourg, with fewer than half a million people, one vote each is really 'democratic'). And, unlike in the UN, where the five permanent members of the Security Council have veto power, no country has a veto in the WTO. Since they have the numerical advantage, the developing countries count far more in the WTO than they do in the IMF or the World Bank.

Unfortunately, in practice, votes are never taken, and the organization is essentially run by an oligarchy comprising a small number of rich countries. It is reported that, in various ministerial meetings (Geneva 1998, Seattle 1999, Doha 2001, Cancun 2003), all the important negotiations were held in the so-called Green Rooms on a 'by-invitation-only' basis. Only the rich countries and some large developing countries that they cannot ignore (e.g., India and Brazil) were invited. Especially during the 1999 Seattle meeting, it was reported

that some developing country delegates who tried to get into Green Rooms without invitation were physically thrown out.

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

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

Are the Bad Samaritans winning?

Margaret Thatcher, the British prime minister who spearheaded the neo-liberal counter-revolution, once famously dismissed her critics saying

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

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

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

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

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

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

Walpole's protectionist policies remained in place for the next century, helping British manufacturing industries catch up with and then finally forge ahead of their counterparts on the Continent. Britain remained a highly protectionist country until the mid-19th century. In 1820, Britain's average tariff rate on manufacturing imports was 45–55%, compared to 6–8% in the Low Countries, 8–12% in Germany and Switzerland and around 20% in France.[17]

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

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

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

The double life of the British economy

The world's first famous free-market economist, Adam Smith, vehemently attacked what he called the 'mercantile system' whose chief

architect was Walpole. Adam Smith's masterpiece, *The Wealth of Nations*, was published in 1776, at the height of the British mercantile system. He argued that the restrictions on competition that the system was producing through protection, subsidies and granting of monopoly rights were bad for the British economy.*

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

By the end of the Napeolenic Wars in 1815, four decades after the publication of *The Wealth of Nations*, British manufacturers were firmly established as the most efficient in the world, except in a few limited areas where countries like Belgium and Switzerland possessed technological leads. British manufacturers correctly perceived that free trade was now in their interest and started campaigning for it (having said that, they naturally remained quite happy to restrict trade when it suited them, as the cotton manufacturers did when it came to the export of textile machinery that might help foreign competitors). In particular, the manufacturers agitated for the abolition of the Corn Laws that limited the country's ability to import cheap grains. Cheaper food was important to them because it could lower wages and raise profits.

The anti-Corn Law campaign was crucially helped by the economist, politician and stock-market player, David Ricardo. Ricardo came

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

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

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

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

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

However, many historians familiar with the period point out

that making food cheaper was only one aim of the anti-Corn Law campaigners. It was also an act of 'free trade imperialism' intended to 'halt the move to industrialisation on the Continent by enlarging the market for agricultural produce and primary materials'.[21] By opening its domestic agricultural market wider, Britain wanted to lure its competitors back into agriculture. Indeed, the leader of the anti-Corn Law movement, Richard Cobden, argued that, without the Corn Laws: 'The factory system would, in all probability, not have taken place in America and Germany. It most certainly could not have flourished, as it has done, both in these states, and in France, Belgium and Switzerland, through the fostering bounties which the high-priced food of the British artisan has offered to the cheaper fed manufacturer of those countries'.[22] In the same spirit, in 1840, John Bowring of the Board of Trade, a key member of the anti-Corn Law League, explicitly advised the member states of the German *Zollverein* (Custom Union) to specialize in growing wheat and sell the wheat to buy British manufactures.[23] Moreover, it was not until 1860 that tariffs were completely abolished. In other words, Britain adopted free trade only when it had acquired a technological lead over its competitors 'behind high and long-lasting tariff barriers', as the eminent economic historian Paul Bairoch once put it.[24] No wonder Friedrich List talked about 'kicking away the ladder'.

America enters the fray

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

Under British rule, America was given the full British colonial treatment. It was naturally denied the use of tariffs to protect its new industries. It was prohibited from exporting products that competed with British products. It was given subsidies to produce raw materials.

Moreover, outright restrictions were imposed on what Americans could manufacture. The spirit behind this policy is best summed up by a remark William Pitt the Elder made in 1770. Hearing that new industries were emerging in the American colonies, he famously said: '[The New England] colonies should not be permitted to manufacture so much as a horseshoe nail'.[25] In reality, British policies were a little more lenient than this may imply: some industrial activities were permitted. But the manufacture of high-technology products was banned.

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

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

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

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

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

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

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

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

Hamilton resigned as treasurey secretary in 1795, following the

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

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

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

Abraham Lincoln and America's bid for supremacy

Although Hamilton's trade policy was well established by the 1820s, tariffs were an ever-present source of tension in US politics for the

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

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

The charismatic Clay stood out from early on in his career. Almost as soon as he was elected to Congress in 1810, he became the Speaker of the House (from 1811 until 1820 and then again in 1823–5). As a politician from the West, he wanted to persuade the Western states to join forces with the Northern states, in the development of whose manufacturing industries Clay saw the future of his country. Traditionally, the Western states, having little industry, had been advocates of free trade and thus allied themselves with the pro-free trade Southern states. Clay argued that they should switch sides to back a protectionist programme of industrial development in return for federal investments in infrastructure to develop the region. Clay ran for the presidency three times (1824, 1832 and 1844) without success,

although he came very close to winning the popular vote in the 1844 election. The Whig candidates who did manage to become presidents – William Harrison (1841–4) and Zachary Taylor (1849–51) – were generals with no clear political or economic views.

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

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

Slavery was *not* as divisive an issue in pre-Civil-War US politics as most of us today believe it to have been. Abolitionists had a strong influence in some Northern states, especially Massachusetts, but the mainstream Northern view was not abolitionist. Many people who were opposed to slavery thought that black people were racially inferior and thus were against giving them full citizenship, including the right to vote. They believed the proposal by radicals for an immediate abolition of slavery to be highly unrealistic. The Great Emancipator himself shared these views. In response to a newspaper editorial urging immediate slave emancipation, Lincoln wrote: 'If I could save the Union without freeing

any slave, I would do it; and if I could save it by freeing all the slaves, I would do it; and if I could do it by freeing some and leaving others alone, I would also do that'.[33] Historians of the period agree that his abolition of slavery in 1862 was more of a strategic move to win the war than an act of moral conviction. Disagreement over trade policy, in fact, was at least as important as, and possibly more important than, slavery in bringing about the Civil War.

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

But, once elected, Lincoln raised industrial tariffs to their highest level so far in US history.[35] The expenditure for the Civil War was given as an excuse – in the same way in which the first significant rise in US tariffs came about during the Anglo-American War (1812–16). However, after the war, tariffs stayed at wartime levels or above. Tariffs on manufactured imports remained at 40–50% until the First World War, and were the highest of any country in the world.[36]

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

Along with the much-trumpeted wisdom of the Anti-Corn Law movement, the stupidity of the Smoot-Hawley tariff has become a key fable in free trade mythology. Jagdish Bhagwati has called it 'the most visible and dramatic act of anti-trade folly'.[38] But this view is misleading.

The Smoot-Hawley tariff may have provoked an international tariff war, thanks to bad timing, especially given the new status of the US as the world's largest creditor nation after the First World War. But it was simply not the radical departure from the country's traditional trade policy stance that free trade economists claim it to have been. Following the bill, the average industrial tariff rate rose to 48%. The rise from 37% (1925) to 48% (1930) is not exactly small but it is hardly a seismic shift. Moreover, the 48% obtained after the bill comfortably falls within the range of the rates that had prevailed in the country ever since the Civil War, albeit in the upper region thereof.

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

It was only after the Second World War that the US – with its industrial supremacy now unchallenged – liberalized its trade and started championing the cause of free trade. But the US has never practised free trade to the same degree as Britain did during its free trade period (1860 to 1932). It has never had a zero-tariff regime like Britain. It has also been much more aggressive in using non-tariff protectionist measures when necessary.[41] Moreover, even when it shifted to freer (if not absolutely free) trade, the US government promoted key industries by another means, namely, public funding of R&D. Between the 1950s and the mid-1990s, US federal government funding accounted for 50–70% of the country's total R&D funding, which is far above the figure of around 20%, found in such 'government-led'

countries as Japan and Korea. Without federal government funding for R&D, the US would not have been able to maintain its technological lead over the rest of the world in key industries like computers, semiconductors, life sciences, the internet and aerospace.

Other countries, guilty secrets

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

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

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

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

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

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

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

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

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

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

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

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

As a result, the gains from trade liberalization in poor countries

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

The short-run trade adjustment problem arising from the immobility of economic resources and the weakness of compensating mechanisms is, although serious, only a secondary problem with free trade theory. The more serious problem – at least for an economist like myself – is that the theory is about efficiency in the short-run use of given resources, and *not* about increasing available resources through economic development in the long run; contrary to what their proponents would have us believe, free trade theory does *not* tell us that free trade is good for *economic development*.

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

In recommending free trade to developing countries, the Bad Samaritans point out that all the rich countries have free(ish) trade. This is, however, like people advising the parents of a six-year-old boy to make him get a job, arguing that successful adults don't live off their parents and, therefore, that being independent must be the reason for their successes. They do not realize that those adults are independent *because* they are successful, and not the other way around.