Try to Answer the Hardest Question in Economics

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(Bloomberg Opinion) -- How poor countries can become rich ones is the most important questions in economics — but also the hardest to answer. Each country can only get rich once, and countries differ a lot, so drawing generalizations from repeated experience is difficult. And the process of development is so complex that economic modelers barely know where to begin. Plenty of economists have proposed general theories of how economies grow, but they're all very challenging to test empirically.

But despite the lack of a general theory of growth, economists who work for agencies like the World Bank and the International Monetary Fund have to give some kind of advice to developing nations. Often, they default to the comfortable old chestnuts handed down from Adam Smith and David Ricardo — open your markets to trade, privatize state-owned industries and don't run big fiscal deficits. Get the government out of the way, and growth will follow.

While there's no doubt that market liberalization can have a bracing effect on a poor country's economy — witness the rapid growth of China after it began to transition away from Maoism, or India after the 1991 reforms — there are also cases where it doesn't seem to do the trick. Post-communist Eastern Europe has made very uneven gains, and Latin America's experience has also been underwhelming.

Meanwhile, every country that has made the transition to developed status since the end of World War II seems to fit into one of three categories — oil-rich states like Brunei and Kuwait, small financial hubs and tax havens like Singapore and Ireland, or countries that make heavy use of industrial policy. This latter category, which includes Japan, South Korea and Taiwan — and may soon include China — is of particular interest, since these countries might provide a blueprint of how big countries can get rich without winning the oil lottery.

So what lessons can these countries teach us? All of them have robust private markets and substantial private ownership. But each of them has also used industrial policy to encourage exports, manage the financial industry and acquire foreign technology — strategies that are noticeably absent from the standard economics playbook.

Some economists have tried to distill the lessons from Northeast Asian industrial policy. These include Bela Balassa, Alice Amsden, Ha-Joon Chang, Sanjaya Lall and Nobel Prize winner Joseph Stiglitz. Some of their insights echo the thoughts of Friedrich List, the German-American economist whose work in the early 1800s helped inspire Germany's industrial policies in the latter part of that century.

But by far the most readable account of the region's industrial policy is "How Asia Works," by journalist Joe Studwell. Breezy and readable yet exhaustively researched, Studwell's book draws on the insights of some of the above economists — as well as various historians and his own reporting — to present a simple unified theory of how poor countries can use industrial policy to get rich.

Studwell believes that good industrial policy boils down to three things. First, developing countries should promote labor-intensive agriculture on small owneroperated farms. Second, once agriculture is going well, countries should focus on manufacturing, and use export promotion as a way to force companies to learn to be more productive. And third, bank-based financial systems should be directed to support export manufacturers.

The second of these turns out to be the centerpiece. Studwell asserts that developing countries grow by upgrading their technology, and that the only way to do this is to learn by experience. And the best way to do this, he says, is for developing-country governments to incentivize their manufacturers to sell their wares overseas. Exporting entails competing in world markets, which forces a country to acquire, adopt and improve on foreign technologies by any means necessary. In economics the bracing effect of international competition is called "export discipline"; Studwell uses this term a bit more expansively, to refer also to governments' practice of disciplining their companies to export, export, export. This echoes the prescriptions of Harvard economist Dani Rodrik, who believes that exporting allows developing countries to discover their comparative advantages in the international trade system.

Notably, many discussions of development focus on net exports— i.e., trade surpluses. Studwell, in contrast, is talking about gross exports — it doesn't matter if a country buys a lot from overseas, as long as it also sells a lot overseas too. South Korea, after all, ran trade deficits during much of its period of rapid growth. Thus, Studwell isn't advocating mercantilism, or growth at the expense of other nations.

Studwell also is no advocate of picking winners, or of promoting national champions. Instead, he advises countries to start out with lots of competing exporters, and then cull the losers by letting incompetent companies go bankrupt, or forcing them to be swallowed by more successful exporters. He dismisses undervalued currencies as an overly blunt instrument, since these reward inefficient and efficient exporters alike.

Thus, Studwell's theory doesn't easily fit into either the free-market or the state-planning paradigm. It's fundamentally about using government intervention to harness the power of market competition. It's not the kind of idea that would sit well with the classically trained economists of the World Bank and IMF. But given the amazing success stories of Japan, South Korea and Taiwan — and now, hopefully, China — it seems like development economists should be working on testing Studwell's ideas to see how well they hold up under rigorous empirical examination.

If Studwell and other supporters of export discipline and learning-by-doing are correct, then the all-important question of how poor countries can get rich doesn't look unanswerable after all. In fact, even developed countries like the U.S. that have low ratios of exports to GDP might have reason to be interested in the idea of improving productivity through export promotion.

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