



ESCAPE FROM EMPIRE

THE DEVELOPING WORLD'S JOURNEY
THROUGH HEAVEN AND HELL

ALICE H. AMSDEN



Escape from Empire

The Developing World's Journey through Heaven and Hell

Alice H. Amsden

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Foreign aid failed as a lever of growth because it was "tied" (Congress decreed that 80 percent of foreign aid had to be spent on American-made goods), it was corrupt (poor countries had no other way to make money), and it was ill conceived: what good is aid to education if there is no coordinated investment in jobs?

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Great Balls of Fire emerged—China, India, and other awakening giants. If the giants prosper, the Second American Empire will no longer enjoy absolute power. Can it adjust?

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8 To Hell in a Straw Basket

The Fed's tight money caused the debt problem. World exports doubled in the decade before that. The GNP of many developing countries doubled in ten years. Nothing like that has ever happened in the history of the world.

Walter Wriston (CEO, Citicorp), quoted in W. R. Neikirk, *Volcker: Portrait of the Money Man*

I The Importance of Being Rich

As inflation in the United States worsened because of OPEC policies and the Vietnam War, the Federal Reserve cut the money supply and raised interest rates. As a result, Third World economies that once delighted in new investment possibilities became destitute overnight.

Still inexperienced, developing countries under the First American Empire were accustomed to financial transactions being heavily regulated. Historically, the quarter-century after World War II was a period of extensive government surveillance. As B. Eichengreen argues in *Globalizing Capital*, "Interest rates were capped. The assets in which banks could invest were restricted. Governments regulated financial markets to channel credit toward strategic sectors." Capital controls were important because "they were part of the series of levees and locks with which the raging rapids were tamed."¹

Banks, bigger and more vociferous than ever, petitioned the Treasury, and the Treasury pestered developing countries to free their financial markets. In 1984 and 1994, the Treasury published tomes that targeted specific institutions in specific countries that were derelict in removing controls. Although still naive, one developing country after another opened its capital markets for foreign business. Edward Bernstein, the U.S. chief economist at

the Bretton Woods Conference in 1944 and Keynes's counterpart, a voice from another era, summed up the tragedy: "Commercial banks were raking in so much money that they didn't care about the danger of a debt crisis. The real surge in lending occurred after the 1979 oil-price increase. Where was the IMF? Where was the Federal Reserve Board? *It almost sounds as if we had inadequate supervision of what the banks were doing.*"²

When Mexico's liabilities to American banks reached \$84 billion and default was nigh, the world's most sophisticated financial services industry was taken by surprise. According to a senior White House official, "Believe me, Mexico was the last thing on our mind."³ As Richard Nixon had said about the developing world a few years earlier, "Nobody gave a damn." The Mexican financial collapse was contagious, and soon other indebted countries were on the verge of a financial crash. Then a lot of people cared.

Creditors can use two generic methods to collect their pound of flesh: They can help debtors grow fat and then skim off the cream, or they can make debtors become emaciated and then grab whatever they shed. Always, bankers have preferred the second method.

The advice of a British commission investigating Turkey's debt problem in the 1860s was indistinguishable from the advice of the International Monetary Fund investigating Turkey's debt problem in the 1980s: "Both programs recommend the government to reduce budget deficits, restrict monetary growth, and ensure real devaluation for short-term stability; and to deregulate markets, curtail the role of the state, and liberalize foreign trade and foreign capital inflows for long-term growth."⁴ Nothing had changed despite all the new sophisticated tools of financial management and flow of knowledge from South to North.

Throughout this collapse, East Asian countries remained unaffected. Their debt crisis struck later, in 1997, which gave them 15 years of solid growth more than other developing regions. China, India, and Taiwan never fully deregulated their financial markets, *and never suffered a debt crisis.*

II Cigar Capitalism

Transparency and the U.S. Treasury are opposites that don't attract. A question and answer period to learn more about the Treasury might run as follows:

Outsider: What made Korea open its financial markets to the tune of \$45 billion just before its financial crash in 1997?

Insider: Uh, don't know!!

Outsider: Well, if I really want to find out, I can. I can sue you under the Freedom of Information Act.

Insider: You do that. It will take about three years for you to get the documents, and then all the names you want to know will be blanked out for security reasons.

Financial markets are highly competitive because billions of dollars flow in and out each day. This means that financial transactions are transparent by definition. But the rules of the game are drawn and enforced by big players. When China's entry into the WTO was being negotiated in the 1990s, "a raft of Wall Street banks, investment banks, insurance companies and other financial institutions... pressured the U.S. Treasury to require China to loosen its capital controls and gradually permit the entry of foreign firms into China's domestic financial markets."⁵ A lack of transparency plus big players are deadly for the poor and powerless.

The financial services sector operated according to reputation and trust—some call it cronyism. When the Third World debt crisis erupted, it was handled by the IMF and Federal Reserve. The managing director of the IMF was Jacques de Larosière, a close friend and fishing partner of Paul Volcker, the chairman of the Federal Reserve. Although this relationship made for good communication, outsiders didn't have a chance.

III Ignorance Is Not Bliss

The petrodollars generated by OPEC flooded financial markets in New York and London in the 1970s, pleasing both lenders and borrowers. Third World borrowers, public and private, saw an opportunity to invest in long-dreamed-of projects that were unprofitable at higher interest rates, such as amusement parks in Buenos Aires and automobile plants in Seoul. The enthusiasm of borrowers is comprehensible, but the zeal of lenders to part with their money is incomprehensible. Why would experienced bankers lend to poor countries that were likely to default?

Petrodollars were so cheap and relending was so profitable that banks earned high rates of return even if borrowers ultimately busted. Incentives

in the private banking sector were also distorted toward *loan-pushing*. The bonuses of loan officers—part of a new global financial elite—often depended on how much they lent, so the incentive was to lend as much as possible and to get another job before a loan fell due. Most borrowing rates were variable, which is what pushed some countries over the edge. When interest rates rose in the American economy, interest rates rose on loans—see the small print.

Where, indeed, was the Federal Reserve Board? The U.S. consumer price index had reached 11 percent in 1978, a rate that was horrific to American pensioners and wage-earners. Americans were unused to banana-republic inflation. Luckily, the Fed was in capable hands, those of Paul Volcker, a consummate civil servant, having spent almost all his life in various government posts, including as Under-Secretary of the Treasury, with only a brief spell at Princeton and Chase Manhattan. At a dinner at Columbia University in 2003 honoring economic reporters chosen as Reuters Fellows, Volcker was asked which economist he respected the most. His answer was Keynes. Then he was asked why he hadn't warned the developing world of his plan to slash the money supply and rein in inflation. He said: "Because they wouldn't have listened."⁶ Volcker's withholding of information from the Third World on a life- and death-policy, if only from absent-mindedness, symbolized the redistribution of knowledge from poor to rich countries. The world was rotating back on its axis.

Keynes once remarked that if you owe a bank \$100 and can't repay, you are in trouble; but if you owe a bank \$100 *million* and can't repay, the bank is in trouble. Wall Street was more vulnerable than other financial hubs because it had lent heavily to Mexico, and Mexico was the biggest developing country to verge on bankruptcy. The IMF and Federal Reserve joined forces and went into action—for a while *laissez-faire* was abandoned.

Mexico pleaded with the IMF and the Fed to let it grow fat and repay its loans with excess blubber, but the moneymen refused. The appeals of Mexican President José López Portillo, responsible for developing Mexico as a major oil exporter, fell flat. Volcker and de Larosière "stood firm against Mexico's efforts to try to keep its spending high and interest rates low and to impose exchange controls and keep wages high." Mexico's Yale-trained finance minister Jesús Silva Herzog even sided against his boss in favor of the moneymen! In López Portillo's teary farewell presidential address a few months later, he apologized to Mexico's poor for letting them down. Silva

Herzog, the former finance minister, became ambassador to the United States. Mexico borrowed more to avert bankruptcy. The strings attached required broad-ranging market liberalization. Mexico's developmental state was dismantled, and its growth rate began its decades-long decline.

According to Henry Kaufman, a big Wall Street bond trader, "Paul Volcker stands out as one of the great central bankers of the twentieth century." According to Walter Wriston, the CEO of Citicorp, Volcker wildly overreacted and killed the goose. (According to an interview with Volcker in the *New York Times*, Wriston saw himself as a rival of the Federal Reserve in terms of his influence on the banking system.)⁷ Whatever the final verdict on Volcker, it is probably fair to say that the bailouts of the 1980s were astonishing for their lack of vision. They carried conditionalities similar to those under colonialism, despite an Asian alternative indicating where the world was going. Even the creditors in Ottoman Turkey did better! They were actively responsible for getting Basra's ancient silk industry up and running in order to generate more revenues for themselves, and they even imposed tariffs to keep domestic silk production going. Nothing as spunky as this activism occurred in the 1980s.

IV Raising the Dead

Washington put its money for recovery on privatizing the Third World's state-owned enterprises and enticing the entry of multinational firms. The debt crisis had devastated Third World companies. But if their ownership was transferred to foreigners, the fittest would survive (as would American industry). With enough foreign direct investment (FDI), it would be possible to raise the dead! In no event were Third World governments allowed into this new business.

From 1980 through 1995, foreign firms increased their share of total Brazilian output from 33 percent to 72 percent in the computer industry (one of the failures of import substitution), from 30 to 57 percent in the electrical machinery industry, from 41 to 64 percent in the nonelectrical machinery industry, and from 46 percent to 68 percent in the chemical industry.⁸ Cross-border mergers and acquisitions in Latin America soared. Foreign acquisitions of companies rose, according to UN data, from \$1.1 billion in 1988 to \$63.9 billion in 1998.

Apart from Latin America's new elite financial managers, whose income depended on takeovers and privatizations, national governments and local companies began to have second thoughts about multinationals outside the labor-intensive industries of export-processing zones. Compared to the *best* nationally owned companies, the *average* multinationals left something to be desired because of their bureaucratic procedures and lack of entrepreneurial spirit. Maybe resources should be shifted to local firms for restructuring?

Bureaucratic control systems slowed the reaction time of foreign subsidiaries. In India's pharmaceutical industry, a local firm could be faster to market than the subsidiary of a multinational that had invented a drug in the first place. Samsung Electronics of Korea was starting to catch up with Sony Electronics of Japan in certain product segments. Embraer of Brazil was closing in on Bombardier of Canada. Tata Steel of India had already closed USX of the United States.

In colonial times, multinationals were rarely the first to invest locally in a new sector, the quintessence of entrepreneurship. They were not leaders, as shown in chapter 2. The experience of nineteenth-century America "strongly supports" this assessment,⁹ as does the history of Japan: "When the Japanese had already demonstrated their general progressive drive and their specific industrial aptitudes, FDI in manufacturing made an appearance."¹⁰ Even in India, foreigners were responsible for starting a few industries, including the railroads, but Indians took the lead in most of the rest.

As noted earlier, televisions were a big-ticket item in the late 1950s that advanced countries began assembling abroad, in their own factories, first in Japan and then in Mexico, Korea, Taiwan, and Singapore. CEOs of Taiwan's electronics companies say they learned modern management from American TV makers, but even here the foreign investor didn't really plough virgin territory. RCA was the first company in Taiwan's TV industry, but a Taiwan company, Tatung, already produced fans and rice cookers (with Japanese technology). Tatung's assembly lines were the teachers of thousands of Taiwanese workers, managers, and engineers. Its demand for parts and components jump-started Taiwan's dense network of small- and medium-sized enterprises, a must for most electronic products. The Taiwan government, recognizing that foreign manufacturers resettle in the country with the lowest wages, introduced incentives for joint ventures to be formed at home with Taiwanese and Japanese TV makers.

When electronic goods such as calculators, computers, and cell phones were outsourced, the multinationals no longer invested at all in their own production facilities abroad; instead, production facilities and detail design were in the hands of Third World companies. The multinationals sent them the basic architecture of a model and they did the rest. Outsourcing allowed the Third World's best firms to corner the market in manufacturing excellence and integration R&D. But indebted Third World enterprises were in desperate need of capital, and this made foreign direct investment look good. Foreign investment also looked good to a second generation of owners that was uninterested in keeping a family business alive.

Two problems plagued foreign direct investment. First, the countries that needed it the most (the poorest countries), received the least. Second, state-owned enterprises were supposed to be privatized to rid governments of lemons. But no one wanted to buy a lemon. Foreigners bought only the best companies that needed privatization the least.

Attracting foreign investment in the poorest countries was always an act of magic. Sir W. Arthur Lewis, who in 1957 wrote the development plan for Africa's first independent country, Ghana, triggered a lively debate over whether to welcome FDI. Finally, Lewis factored in a role for it. But no investment came, except to mine Ghana's raw materials. Just as most foreign investments in manufacturing went to (and came from) North America, Europe, and Japan, the share to developing countries was concentrated in Brazil, Malaysia, Mexico, Singapore, and eventually China.

Foreign investment can go a long way in a poor, small country. Between 1991 and 1996, FDI *as a percentage of gross fixed capital formation* was as high as 24 percent in Swaziland (a South African offshoot), 29 percent in Singapore (an active suitor of foreign investment), and 38 percent in Trinidad and Tobago (an oil-rich Caribbean island), all minuscule economies. Sometimes the share spiked in "hot" countries: oil-rich Nigeria (29 percent), touristy Guyana (35 percent), and opportunity-rich Vietnam (35 percent, where most investors were Asian).¹¹ Given Mexico's location, its comparative advantage was economic integration with North America. American investments in the *maquilas* in Mexico's export-processing zones boomed, but the rest of Mexico's economy was as slow as a graveyard. Even factories from the north began heading for China.

The average developing country was always being told to give itself away in marriage to a foreign direct investor even though such an investor had a

small dowry. FDI accounted for a minuscule share of the South's capital formation outside the few examples named above. In the 1990s, the *average* annual share of FDI in capital formation was 4.4 percent in the world, 5.5 percent in the European Union, 6.5 percent in developing countries (including raw materials), 5.3 percent in Africa, 6.9 percent in South America, 1 percent in the Middle East, and 11 percent in China. In countries actively committed to growing their own national enterprises, the share of FDI was minuscule: 1 percent in India, less than 1 percent in Korea, about 2 percent in Taiwan, and below 4 percent in Thailand.

Under the Second American Empire, the natural-resource sector of poor developing countries was already owned and controlled by foreign companies, oftentimes very mean-spirited ones (Pechiney, the French giant multinational from colonial days, owns 51 percent in a holding company of alumina production in Guinea, which has the world's largest bauxite reserves, the second largest bauxite production in 2001, and the rank of only 159 out of 173 in the UN's human development index). Under foreign ownership of raw materials, profits were generally repatriated, and tax rates and royalties were a constant source of conflict with weak local governments. Exempting the era of the First American Empire, nothing much changed in the natural-resource sector from the colonial period to the Second American Empire. Because a large share of the wealth of the poorest countries was already under foreign control, and the poor didn't seem to be getting richer—if anything, they were becoming poorer—a development policy based on more foreign investment was blind.

Many poor countries nationalized their raw materials under the First American Empire and got away with it. They created state-owned enterprises that usually operated jointly with a foreign mining company. In most cases, corruption was kept to a minimum. Chile and El Salvador nationalized Anaconda Copper late, in the period from 1966 to 1976, but Chile kept mining under state ownership even during the neoliberal Pinochet dictatorship. Countries nationalized their raw materials to increase their tax receipts and royalties, which were important sources for financing their development, and for training local labor for managerial positions. Labor conditions at the time were primitive. Duncan Kennedy, a summer intern at Pechiney-Guinea in 1962 (and now a professor at Harvard Law School), interviewed African miners about promotion. Almost all claimed that most French supervisors were racist. When he reported

a serious race relations problem to the chief operations officer, he was shown the door.

Under the Second American Empire, ownership went the other way: most state-owned mining enterprises were privatized. Canadian mining in Latin America exploded. Investors responded with policies of deregulation, privatization, state-downsizing, and export promotion encouraged by the International Monetary Fund and the World Bank.

Poor countries in the late 1980s, especially in Africa, needed the money from selloffs of their assets to balance their fiscal accounts. But ironically, privatization and tax incentives for foreign investors decreased government revenues from the mining sectors. Privatization was not only expensive but was also a one-shot deal.

In the early 1990s, the top 15 state-owned enterprises in the South were all in heavy industry. Out of 15, 13 were in petrochemicals or metallurgy, mostly iron and steel (see table 8.1). These were national champions with

Table 8.1

The Developing World's Top Fifteen Public Enterprises in Manufacturing, Ranked by Sales, Selected Countries

	Sales (mil US\$)	Name	Country	Activities
1	21,023	Petroleo Brasileiro	Brazil	Petroleum
2	20,270	Petróleos Mexicanos	Mexico	Petroleum
3	11,836	Chinese Petroleum Corp.	Taiwan	Petroleum
4	9,900	Pohang Iron & Steel	Korea	Iron, steel
5	8,077	Indian Oil Corp.	India	Petroleum
6	6,833	Vale do Rio Doce	Brazil	Minerals, metals, paper
7	6,821	Petrobras Distribuidora	Brazil	Petroleum
8	5,924	Pertamina	Indonesia	Petroleum
9	4,021	Steel Authority Limited	India	Iron, steel
10	3,865	Taiwan Tobacco & Wine	Taiwan	Tobacco, spirits
11	3,207	Oil and Natural Gas Corp.	India	Petroleum
12	3,002	Hindustan Petroleum	India	Petroleum
13	2,490	Petronas*	Malaysia	Petroleum
14	2,126	Bharat Petroleum	India	Petroleum
15	1,201	Bharat Heavy Electricals	India	Diversified

*Sales figures are for 1990.

Sources: See citations and notes in Amsden (2001), p. 214.

few, if any, shades of corruption. They created de novo organizations, accumulated high levels of both managerial and technological capabilities, and diffused these capabilities to the private sector. Every state-owned petrochemical company spun out national chemical manufacturers downstream.

One way or another, the most powerful state-owned enterprises in savvy countries retained their national identity (except in Argentina). The most nationalistic, such as POSCO, Usiminas, and Vale do Rio Doce (Brazil's premier metallurgical company), were privatized such that no single owner emerged and the government retained a stake. Usiminas's voting shares were distributed among pension funds (26.8 percent); financial organizations (23 percent); Companhia Vale do Rio Doce, which was itself sold to multiple owners (15 percent); Nippon Usiminas (13.8 percent), an original owner of Usiminas that was owned by Shin Nippon Steel; employees and employee pension funds (11.1 percent); and steel distributors (4.4 percent). Of 24 major Brazilian properties auctioned in 1991–1993, only 12 had a single major buyer. POSCO (Korea) was sold publicly to relatively small holders. To avert a hostile takeover, it arranged an equity deal with its old teacher, Shin Nippon of Japan. The inner core of Sunkyong, a major Korean business group, was Yukong Oil, a former public holding.

Unless a country has its own nationally owned firms, it can't "globalize" in the form of outward foreign investment. If only foreign firms exist in a developing country, the overseas investments of these firms can't redound to the developing country. Nationally owned firms continued to receive help from Third World innovation systems and the residual institutions that didn't die with the First American Empire. But in general, the Third World was starved for foreign capital to revive its own private enterprise—a victim of the North's fear of "excess" competition and the resurrection of the developmental state.

V Brains or Brawn?

The world changed when Paul Volcker's pen slashed the U.S. money supply without any warning to Third World creditors. The First American Empire received a second bullet through its heart, and this one hit the Third World as well. Countless developing countries fell into debt traps that kept them in the economic doldrums for decades. The medicine of privatization and foreign investment turned out to be weak tea.

Debt was the cost of deregulation of financial markets in countries without the institutions to support wild fluctuations in the supply and demand of capital. Inflows led to euphoria, but the ends didn't justify the means. Outflows led to euthanasia. Where is the accountability of those who assumed that wholesale deregulation of financial markets was *everywhere* right? Where was the transparency that the Treasury preaches?

It is best to think of accountability in terms of ideas rather than people. The Second American Empire's ideas were like a giant iceberg—dangerous because of their immutability and mostly out of sight.

As the slowdown in growth continued, the job of restructuring the Third World's debt-damaged business enterprises became more urgent. Companies had to be repaired and rationalized before they could be sold or saved. This job became harder and harder, given the Second American Empire's dislike of the developmental state.