Economist.com

Articles by subject: Topics: Economics

ECONOMICS FOCUS

Economics focus

Finding your niche

Feb 27th 2003
From The Economist print edition

The discovery of poor countries' industrial strengths is a matter of trial and error

WHEN developing countries turn to economists for advice on trade, they are usually pointed towards David Ricardo. According to his law of comparative advantage, formulated some 180 years ago, countries should specialise in whatever they are best at producing, leaving their trading partners to provide everything else. In Ricardo's illustrative model, the answers were clear: Portugal, blessed with a fine climate, should cultivate wine; England, blessed with capitalists, should manufacture cloth. The Portuguese gained from importing English cloth (even if they could make it more efficiently) because it freed them to concentrate on wine. As for the English, even the most ardent mercantilist would rather they left viniculture to others.

But if a country's God-given advantages were clear to Ricardo, they are less so in modern practice. Capital is mobile across borders, and the gifts of nature count for little now that manufacturing eclipses agriculture in world trade. A country's place in the global economy seems neither predestined nor predictable. As Ricardo Hausmann and Dani Rodrik, two economists at Harvard University, put it in a recent paper*, economic development is a haphazard process of “self-discovery”. Comparative advantage is almost impossible to spot in advance.

Bangladesh, for example, is good at exporting hats, having sold $175m-worth to America in 2000. At one level this is not surprising. Bangladesh is overcrowded and underserved by capital; much of its arable land is periodically under water. As any economist could tell you, it therefore has a comparative advantage in labour-intensive manufactures. But why does Bangladesh specialise in hats rather than, say, bed-sheets? And why did Pakistan, a country with a similar mix of land, labour and capital, export $130m-worth of bed-sheets to America in 2000 but a mere $700,000-worth of hats?

Mr Hausmann and Mr Rodrik cite many examples of countries that have happened upon a lucrative export niche—cut flowers from Colombia, software from India, footballs from Pakistan—to which raw factor endowments give only the roughest of guides. Nothing written by Ricardo, or by anybody theorising since, could have told a budding Bangladeshi entrepreneur to make hats rather than bed-sheets.

Sometimes governments try to force the issue. In 1896 Japan's rulers deemed that their country should have a steel industry to match the best in Europe. Imperial say-so substituted for economic know-how, but met with little success. The government went to great lengths to replicate European technology, importing German engineers, machines and designs. Only after a steel mill had been built did it become apparent that German mills could not run on Japanese coke.

Performing the hat-trick

Neither economists nor emperors can be relied upon to pick winners. The best bet is entrepreneurial trial and error. Messrs Hausmann and Rodrik build a theoretical model in which businessmen in a poor country can choose either to invest in a traditional domestic industry or to diversify into a modern industry in which there is no local history of expertise. The costs of production in the traditional industry are well-known; costs in the new industry are not. Entrepreneurs discover these costs only after they have sunk money into the project. Their investments are, in effect, industrial-scale experiments. Profitable or not, they reveal a country's strengths and weaknesses.

The authors think that entrepreneurs in developing countries may lack sufficient incentives to invest in new industries. Businessmen will take the risk of innovation only if they have a chance of creating some sort of monopoly. They may be helped by patents, trademarks or copyright; if not, they will have an edge only until rivals catch up. In poor countries, the chances are that patents and so on will help less than in rich ones, largely because investors are trying out technology that already exists abroad. So the entrepreneur who first decides to export cut flowers from Colombia to America, for example, cannot hope to stay ahead of imitators for long. His fellow countrymen will rush to copy his business model, poach his staff and encroach upon the ground he has broken.

To create a greater incentive to experiment in new industries, say the authors, there may sometimes be a case for governments to protect companies in infant industries from unfettered competition. This does not mean tariffs, which protect all domestic companies to the same extent; rather, it implies finding ways to help innovators against domestic imitators. The trouble is that this is a much harder trick to pull off in practice than it looks in theory. Latin American development banks used to reserve preferential credit for the first domestic entrant in any industry—raising the potential profits available to innovators. Under such policies, Latin America became a veritable hothouse of industrial diversification. Unfortunately, governments did not weed out failed industrial experiments, instead keeping them alive alongside thriving ones.

Even successful policies can have damaging side-effects. Messrs Hausmann and Rodrik point to South Korea's willingness, during its drive for industrialisation from the 1960s, to use control of bank credit to reward successful companies and penalise poor performers. Yet by the 1990s the channelling of credit to favoured companies had wrought huge damage to the Korean financial system. Devising industrial policy, like divining comparative advantage, is a matter of trial and error. Many governments have tried; most have erred.

---

* "Economic Development As Self-Discovery". National Bureau of Economic Research Working Paper, Number 8952, revised November 2002.
