I J Macfarlane: Geography, resources or institutions?

Talk by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, to “The Bottom Line” Luncheon, Melbourne, 25 August 2004.

* * *

It is always a pleasure to be in Melbourne, particularly when I am in these gracious and peaceful surroundings and contributing to such a good cause as the Bottom Line Luncheon. By a strange coincidence the Patron of the Foundation is Hugh Morgan, my fellow Board Member of the Reserve Bank, and the Chairman is Professor Adrian Polglase, an old school friend. How could I refuse the invitation to speak today?

I notice on the invitation that I am listed as speaking about the economic outlook. I am afraid the author of the invitation took a few liberties here, and so I will disappoint those who are expecting an analysis of current economic conditions and prospects. We at the Reserve Bank put out an exhaustive account of these earlier in the month and my deputy elaborated on them a week ago. A third rendition within a month would be counter-productive, so I will speak on a different topic, although it could be considered my views on the economic outlook in a very long-term sense.

I would like to look at the factors that shape the economic success of a country in the very long run - that is, over the centuries - and, of course, I will pay particular attention to Australia. I propose to do this by briefly examining four factors which influence growth, and which can be summarised by four distinctive catchphrases: the tyranny of distance, geography is destiny, the resource curse, and institutions matter.

(a) The tyranny of distance

The first factor is a country’s position on the map - its distance from other countries or its degree of isolation. My remarks on this will necessarily be heavily influenced by Geoffrey Blainey’s classic study which originated the term.

We have always assumed that Australia was at a disadvantage because of its relative isolation from the world’s great centres of commerce. This has certainly been true from the beginning. The late start of European settlement was not just because they took so long to find us, or that for the first two hundred years Europeans only sighted the barren north west coast. Even if they had found the temperate east coast two hundred years before Cook, there would not have been an economic reason to occupy the land. There were no valuables to be exchanged with the native population, such as precious metals and spices, and no case for permanent settlement because the American continent offered everything we could offer and was much closer. It was only a couple of coincidences that caused the British Government to take the extraordinary decision to establish a settlement at a place only once visited, and at the other end of the earth.

This isolation continued to disadvantage us economically despite our abundant resources and relatively small population. Transport costs were enormous and delays immense. It took five months to reach England by sail, and even when steam replaced sail and modern ocean liners replaced steam, it still took about four weeks for the journey. Air travel has shortened it to about 24 hours, but it took ages for us to forget our old attitudes.

We were accustomed to an overseas trip, even a business trip, being a long drawn-out affair. We had occasions before air travel when Australian Prime Ministers would spend more than a year at a time in London. Going over old Reserve Bank records of the 1960s and 1970s, I noticed earlier Governors going on business trips that lasted seven weeks. Today a one-week business trip is a long one. Modern transport and communications have enormously reduced the tyranny of distance, even if it has made our lives more hurried.

The other factor that has reduced the tyranny of distance for us is the growth of Asia. The Atlantic Ocean, with Europe and America on each side, is no longer the undisputed centre of world economic activity. Asia and the Pacific Rim, while not as rich as the Atlantic, are clearly the area of fastest

growth and largest population. This has presented enormous opportunities for Australia and, by and large, we have been adaptable enough to seize the chances offered. But it still has not completely dispelled the tyranny of distance. For example, many international companies headquartered in the United States or Europe still find it more convenient to put their Asian headquarters in Singapore, Hong Kong or Tokyo because they are only one flight away from headquarters, whereas major Australian cities are two flights away. We should also remember that Australia's capital cities are in its southern half, while the capitals of our big trading partners - Tokyo, Seoul and Beijing - are in northern Asia. It would be easier if we were talking about Darwin and Jakarta, but that is not where the real action is.

(b) Geography is destiny

It is widely believed that geography determines whether a country will be rich or poor. This is because most of the world's poorest countries are nearer to the equator than the richer ones. Being in the tropics is thus regarded as condemning a country to relative poverty. Of course, this does not have much relevance for Australia because the populous two-thirds of our country is in the temperate zone.

But it is also interesting to reflect on the question of why we should expect a hot climate to be associated with poverty. It certainly was not always so; in fact it was the opposite. For example, in pre-Columbian America, it was the hot areas populated by Aztecs, Incas and Mayans that were richer than the temperate areas. In 1667, under the Treaty of Breda, the Dutch gave up their claims on Manhattan to the English in order to retain the island of Run (in what is now Indonesia). The superior value they placed on Run was due to its being the world's principal source of nutmeg. In the 18th century, France had only enough armed forces to protect one of its two main American possessions - Canada and Haiti. It chose the latter because it was more valuable, being a major producer of sugar.

Even in recent years, some of the success stories among developing economies have been in tropical climates - Singapore, Hong Kong, Thailand, Malaysia and, until recently, Indonesia. Certainly, a tropical climate does not condemn a country to poverty, even if most of the world's poverty is in the tropics. As I will explain later, the correlation between geography and poverty can be explained at a deeper level by institutional factors and the incentives that businesses and workers face. There is, however, a lot of evidence suggesting that to be landlocked and in the tropics is so big a disadvantage that no country has yet overcome it. Sub-Saharan Africa is the best example of this.

(c) The resource curse

There is a widespread view that countries with abundant resources (particularly of minerals and oil) under-perform resource-poor countries. There is even some statistical evidence to suggest that this has happened *on average* over the post-war period.[1]

The arguments behind this relationship are based on the belief that:

- possession of resources is a windfall which makes the community less energetic in pursuing other economic activities;
- resource extraction is a low-tech/low value-added activity; and
- the price of resources inevitably falls relative to the price of manufactured goods.

The first response to this thesis is to recognise that, even if true, it only applies *on average* and that there are many cases where the opposite applies. We are all aware of the failure of countries such as Nigeria and Venezuela to capitalise on their oil reserves, the Congo (Democratic Republic) on its copper, or Argentina on its pastoral resources. But could anyone suggest that rich countries such as Australia or Canada have been disadvantaged by their possession of mineral wealth. A better example still is the United States, "which was the world's leading mineral economy in the very historical period during which it became the world's leader in manufacturing (roughly between 1890 and 1910)."[2] The answer again is that economic success or failure depends on the institutions and

---

[1] Auty (2001), Sachs and Warner (2001), Sachs (2003).

[2] Wright and Czelusta (2004).

incentives. Those countries that get these right will not suffer a resource curse, but those that get them wrong and allow policy to be dominated by a self-defeating battle over economic rents will under-perform.

The assumption that the extractive industries are low-tech is also quite wrong. If they are conducted efficiently, they are very knowledge intensive and research is continuing to lead to many technological breakthroughs. Of course, it was not always so. "Australia was a leading gold-mining country in the nineteenth century, but was an under-achiever with respect to virtually every other mineral, particularly coal, iron ore and bauxite. . . . Australia's share of world production lagged well behind its actual share of mineral wealth (based on modern estimates). In a nation with a strong mining sector and a cultural heritage similar to that of the United States, why should this have been so?"[3]

The answer is that we did not have the right set of institutions or sufficient technical know-how to compete with the world's best. That is no longer the case since a complete change of mindset in the 1960s. For example, R & D expenditure by the mining sector now accounts for almost 20 per cent of R & D by all industries in Australia, and we lead the world in mining software, with one estimate suggesting we now supply 60 to 70 per cent of mining software worldwide.[4]

On the third point about the prices of resources falling relative to the prices of manufactured goods, I will say little because I have covered this point so many times before. Suffice to say that after an 80-year trend-fall, Australia's Terms of Trade - which is the ratio of our resource-intensive export prices to our manufacturing-intensive import prices - bottomed in 1985 but have on average risen since. More importantly, few now doubt that it is manufacturing prices which are under continued downward pressure as a result of the rapid expansion of capacity in Asia, particularly in China.

(d) Institutions matter

More and more, development economists and economic historians are coming to the conclusion that, at the deepest level, a sound institutional framework is the crucial ingredient for sustained economic performance, and that it is far more important than distance, geography or the presence of resources. One only has to look at the extreme differences in economic performance between South and North Korea, or West and (formerly) East Germany to see how different institutions can outweigh the same geography, culture and resources. The different economic performance of Australia and Argentina is another clear case, as is the more general economic superiority of the former British colonies over the former Spanish colonies, which has been a subject of recent studies emphasising the importance of institutions over geography.[5]

What are the "deep" institutions that are conducive to sustained economic performance?

- The first one is the enforcement of property rights. No-one will venture capital for an economic project if success leads to confiscation by the government or other powerful forces. Thus, the enforcement of property rights means a strong body of commercial law (particularly the law of contract), impartial courts, honest police force, etc. It also means eliminating, or at least minimising, corruption. It often used to be thought that corruption "greased the wheels of commerce" and helped things get done. But modern research has unequivocally shown the higher the level of corruption, the worse the economic performance.[6]
- The second institutional requirement is constraints on the ability of government or other elites to exercise arbitrary power. This usually means an open society, democratic political system and a free press, but I would also add institutions that encourage competition by challenging monopoly powers. An important ally in this is the openness of the economy to

---

[3] Wright and Czelusta (ibid).

[4] Stoeckel (1999).

[5] Acemoglu, Johnson and Robinson (2003).

[6] Mauro (1995).

international trade in goods and ideas, which has been shown to have a significant correlation with economic performance.[7]

- Some degree of equal opportunity so that people can invest in human capital formation. In this area, by far the most important component is access to education and an economic structure where positions of importance and authority are open to all comers on the basis of merit.

The term "deep" is used to describe the above institutions because they are embedded in laws, constitutions and culture and are not amenable to quick change. In addition to the deep institutional framework, there are a number of other practices and policies that a country has to get right in order to achieve sustained growth in living standards. The most obvious ones, from my perspective, are sound monetary and fiscal policy and a resilient exchange rate regime, but there are many more that space does not permit me to list.

It takes decades, or perhaps centuries, for deep institutions to evolve, and many attempts to simply impose these institutions in developing countries have failed. But that does not mean the process should not be continued, only that it needs to be done more sympathetically whereby the local population become more involved and can feel they own the reforms.

For countries like Australia, that start with basically good deep institutions, the job of maintaining the standard is easier, but it still requires constant attention and change. For every reform that protects the weak against the strong, there are other reforms that break down some cosy arrangement and thus reduce the level of security for the weak or for the weak and strong alike. Useful reforms will often be opposed by either organised labour or organised business, and sometimes the one reform will be simultaneously opposed by both. It is always difficult when a reform has major distributional consequences.

Fortunately, in my own area the distributional consequences are of secondary importance, and with the benefit of hindsight, reform has been easier than in many other areas. The transition from a monetary policy regime that had quite short horizons, a multitude of aims and where daily decisions were taken politically as in the 1970s and 1980s, to the one we have today was achieved within a decade. It is often the case that reforms that seemed difficult at the time are well accepted in retrospect, and may even come to be seen as inevitable. The present monetary policy regime based on central bank independence and an inflation target was controversial a decade ago, but with good results now on the board it has undoubted bilateral political and community support. Similarly, the floating of the exchange rate was a decision that was hotly debated over a long period, but does anyone want to go back to any of the variants on a fixed exchange rate regime that preceded it? More controversial were the reductions in tariffs that have occurred over the past thirty years, but here again there are few voices that would wish to turn the clock back. Or would we wish to go back to the immigration policy we had during the first half of the twentieth century? The list could go on and on.

It is the nature of a first-rate democratic country that it will constantly be involved in economic reforms, or at least constant updating of its economic framework, and that the changes involved will generate political uncertainty and resistance. But that is the price of achieving and maintaining a first-rate set of institutions, and that is an essential condition for our continuing economic prosperity.

Bibiliography

Acemoglu, D., Johnson, S. and Robinson, J., "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution", *Quarterly Journal of Economics*, November 2002.

Auty, R., "The Political Economy of Resource-Driven Growth", *European Economic Review*, 45, 2001.

Baldwin, R.E., "Openness and Growth: What's the Empirical Relationship?", *NBER Working Paper* 9578, 2003.

Blainey, G., *The Tyranny of Distance*, Macmillan, revised edition 2001.

Dowrick, S., "Openness and Growth", in *International Integration of the Australian Economy*, Reserve Bank of Australia, July 1994.

[7] Dowrick (1994), Baldwin (2003).

Gylfason, T., “Institutions and Economic Performance”, *CESifo DICE Report* 2/2004.
Mauro, P., “Corruption and Growth”, *Quarterly Journal of Economics*, Vol. 110, No. 3, 1995.
Sachs, J. and Warner, A., “The Curse of Natural Resources”, *European Economic Review*, May 2001.
Sachs, J., “Institutions Matter, But Not for Everything”, *Finance and Development*, June 2003.
Stoeckel, A., *Minerals: Our Wealth Down Under*, Canberra, Centre for International Economics, 1994.
Wright, G. and Czelusta, J., “The Myth of the Resource Curse”, *Challenge*, March/April 2004.