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Middle income trap or growing pains?

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There is nothing extraordinary about countries in the middle income category. When they stagnate, it is for normal economic reasons, rather than because of the mythical importance of their level of development. If anything, as most current long-term growth projections indicate, it is the advanced economies who are closer to a situation which might well be dubbed a high income trap. Data shows that economies in the middle-income category achieved higher growth in the years 1950-2010 than those with other income levels. All countries, even the most successful ones, suffer growth slowdowns. There is nothing peculiar to the middle income range in explaining the reasons why this should happen.

From resource-driven to productivity-driven growth

The concept of the middle-income trap was first proposed by Indermit Gill of the World Bank and Homi Kharas, currently of the Brookings Institution. It has since made such strong inroads in the policy debates that it is often taken for granted. The concept makes the assumption that middle-income countries themselves by neither having access to the best technologiesz, which are the domain of the richest countries, nor the lowest wages, a strength of the poorest economies. The latter benefit from the fact that bringing people from the countryside to the cities and into the factories makes them substantially more productive. However, as the marginal returns on resources fall, transition needs to be made to productivity-driven growth or otherwise the stagnant levels of income will become entranched. This requires not only assembling products designed elsewhere, however high-tech they might be, but also investments in research and development into new products. The theory of the middle income trap seems to suggest that is easier to make the transition from low-income to a middle-income economy than from there to a high-income one.

The transition does not have to be a quantum leap from one model to another. In reality, as the Economist has recently reminded us[1], the evolution tends to be continuous. One case in point is China where many people have worried that the exhaustion of surplus labour would lead to a sharp decline in growth dynamics. In fact, the contribution to growth from the movement of workers between agriculture, industry and services has been very modest in recent period. Another example is Brazil where big reforms are anathema while the social contract dictates that changes should happen only little by little.

[1] „Middle-income claptrap“, the Economist, 16 February 2013.

The first transition has to do with the handling of the falling input to growth from labour supply as a result of rapid ageing. Even when its contribution to growth is effectively replaced, there remains an enormous social problem with the need to secure appropriate safety nets and address the problem of inequalities. The prospect for China is that of a collapse in the support ratio of working age people to the retirees, from five to two, the related decline in savings and a parallel rise in entitements.

It is political and structural reasons which can place a lid on total factor productivity. The challenge of reform can easily beging to look daunting to the political leaders. Tendency is often to extend the lifeline of a model which has worked well, even if its use-by-date is approaching. As the Chinese model of agressive utilisation of capital and labour to sustain growth comes under pressure, the debate intensifies on economic remodelling as the right answer to the exhaustion of the earlier drivers of growth. The irresistable temptation remains, nevertheless, to continue alongside hitherto lines by easing monetary policy and continuing infrastructural spending. Overinvestment which this creates will make the economy less stable in the longer-term.

From „embedded liberalism“ to the Golden Straitjacket.

Prior to the current period, not many countries managed to advance quickly. They were chiefly Western European ones, followed by Japan and then the East Asian „tigers“. A 2012 World Bank report showed that as few as 13 of the 101 countries considered to be middle income in 1960 managed to clime up the ladder to high income by 2011[2]. South Korea is one of the best examples of a country which has made the leap into the group of most advanced economies in the world.

For some observers, the middle income trap applies to everybody and what differs is the length of the time to overcome it. Zheng Bingwen, director at the Chinese Academy of Social Sciences and scholar of the middle income trap, claims that „Japan spent 12 years to get out of the trap, Singapore spent 11 years, Hong Kong spent 11 years, and Korea spent only 7 years”[3].

Explantions for countries‘ economic rise have varied from reasons of geography, as in Jared Diamond’s „Gunds, Germs and Steel“ through culture to politics, most recently argued by Daron Acemoglu and James Robinson in „Why Nations Fail“. The book spans centuries and continents, from the legacy of British colonialism in the US to the economic and political impacts of the Black Death in Europe onto the political turmoil in Egypt in 2011.

In the postwar period until the 1980s, countries followed different growth models under the system which John Ruggie described as „embedded liberalism“ which allowed for divergent economic policies under the assumption that the bulk of trade restrictions would be lifted, althouth not on capital flows, and the principle of non-discrimination would be obeyed. Within the confines of this system, Japan grew on the back of a powerful export machine, although its services sector remained inefficient. Latin America, the Middle East and Africa relied on import-substitution policies while most of East Asian economies rose through agressive industrial policies.

From the 1980s onwards, a new paradigm emerged which Thomas Friedman has dubbed the Golden Straitjacket. International markets have become the arbitors of economic policy, rewarding countries which play by the rules and penalising those that create barriers to economic exchange. Attractiviness in the eyes of the markets became the primary driver of reform. „Once your country puts on the Golden Straitjacket, its political choices get reduced to Pepsi or Coke“, Friedman wrote, reflecting the tight parameters that the integrated global economy required. Emerging economies have struggled to combine allegience to those rules with a high degree of state interventionism and often a blatent distaste for the liberal rule-book.

[2] „China 2030: Building a modern, harmonious and creative high-income society“, World Bank 2012.

[3] Chen Xiaoyi, „China to stride over middle income trap between 2021-2025“, Morning Whistle, 9 November 2012.

Developmental exhaustion

The transition into middle income status is demanding in socio-political terms as new aspirations are created. The mindset risks getting stuck in a „rents-seeking“ mode without moving on to enlarging the pie. The example of India has shown how the government's economic policy can quickly focus on entitlements, such as the right to education and work, and not on labour market reforms. The challenge for the political level then becomes how to cater to the higher expectations. This is often done in a way which sacrifices the economic fundamentals and „crowds out“ that part of public spending which can contribute to rises in productivity. In addition, an entitlement culture is born and the political system is quickly tested in mediating between the different interests.

Acemoglu's and Robinson's answer is that it is all in the institutions. Property rights, economic freedom, level-playing field and effective enforcement matter more than anything else. It is the task of governments to build and operate successful institutions. Without them, people would have no incentive to take risks and innovate. Clearly, institutions cannot be copied and pasted into the system, they need to be worked out through the political process. It is also the political process that preserves them. The key characteristic of the successful institutions which contains a secret to their durability is inclusiveness. It is needed to guard against attempts to give them institutions an extractive character. By formulating the argument in this fashion, Acemoglu and Robinson attempt to merge the right wing belief in the power of rights and incentives with empowerement of the citizens which is close to the hearts of the left-wingers. In another take on the subject, the vanguard of thinking about the centrality of institutions for growth, Mancur Olson, argued that the crucial role is played by „market-augmenting government“. Competing economic interests within societies and the way they are mediated is central to the effectiveness of the institutions.

In practice and at a closer inspection, the marriage between politics and economics is a two-way street. The building of successful institutions does not take place in a vacuum. Fertile economic ground is important.
The British welfare state was possible because of the gains made in the course of the Industrial Revolution which, on the other hand, grew on the fertile ground of a more pluralist political system after the Glorious Revolution of the 17th century. One obvious current example where the quality of state institutions weighs heavily on economic performce is India with poor infrastructure and energy blackouts. India would have every reason to expect growth in the range of about 10 percent. Instead, a more realistic sustainable growth rate is closer to 5 percent. The debate in India is now increasingly about „inclusive development“ where the redistribution-first model needs to be replaced by a more growth-friendly one with inefficient subsidies being replaced by direct aid for the least affluent and the nexus between big business and big government being broken. Across the emerging economies, inequality will remain a massive challenge. Among the BRICS countries, it is only Brazil that has substantially reduced social inequalities and economic poverty in the last decade although it is still nowhere near West European levels.

Avoiding the trap as a mobilising objective

Sebastián Piñera, the Chilean President has recently defined it as his legacy objective to make Chile a developed country by 2018. This would mean reaching the level of per capita GDP of 22 k USD, similar to that of Portugal (today's level in Chile is 15 k USD). Similarly, President Hu Jintao of China announced on 8 November 2012 in the keynote speech for the 18th National Congress of the Communist Party of China that by the year 2020, China will become an entirely affluent society with the doubling of income compared to 2010 levels.

The same is true for Malaysia where Prime Minister Najib Razak has launched a reform programme called the New Economic Model. Malaysia is an interesting case from the point of view of the middle income. The country has registered remarkable progress in the last few decades. Welfare improved markedly from the situation in which 50% of the society lived in absolute poverty in 1970 and is today less than 4 percent. Yet, the feeling in the country is that of others having progressed faster. South Korea, whose per capita GNI was below Malaysian one in 1970 is now three times richer. One of the reasons is that the country maintained the same growth model with export-oriented manufacturing based on foreign investment as the main driver. Multinational companies have brought with them capital, know-how and technology. Since the model generated a decent delivery, little has been done to increase innovation and move up the value-added curve. Spending on research and development is at a frustratingly low 0.6 percent of GDP, private investment has been falling since the mid-1990s while labour productivity stalls.

Middle-income trap in times of crisis

The economic crisis puts the challenge of the middle-income trap in a new light. As the pool of resources becomes more clearly finite, the balance will be redefined between the individual and the collective. The state will change its function to that of „insurer of last resort“, providing for the survival of the economic base but engaging less in the delivery of public goods. As sustainability of public finances becomes a value in itself in the dominant economic paradigm, more responsibility for their own prosperity will rest on individuals.

In a world with such characteristics, education and skills become essential qualities for ensuring social mobility. Last year's Pearson report about the quality of the education systems, argues that it is not necessarily the amounts of money spent on education which matter but support of the surrounding culture. Reforming the education system in the midst of the transformation and extending the time-frame of schooling by one year proved to be crucial for Poland's performance in the PISA ranking, measuring the skills of 15-year olds. In interpreting written texts, Polish youth is on the 15th position (2009 PISA ranking) while in the overall assessment of the education system carried out by Pearson in 2012, Poland is 14th. More action will be necessary with respect to e-skills. The EU has recently launched the idea of „digital champions“, national coordinators in charge of running massive public awareness campaigns, showing how digital technology is changing the world and what it enables.

More competitive international environment

What Donald Rumsfeld has called the „unknown unknown“ is how the international environment will change as well as what broader, structural shifts are likely to happen in the world economy. One of them has to do with the future of manufacturing where advanced technologies and growing demand for locally produced and customised production will affect the existing global supply chains and outsourcing models. Countries, such as China, with a strong position in complex global supply chains, might be the biggest losers of this shift.

Such developments make the need for moving up the value-added curve more urgent. The focus on institutions is crucial as their importance for sustainable development tends to grow with the rising income per head. An entrepreneurial culture that nurtures and protects innovators is also fundamental. It is this culture, combined with well-functioning institutions that can help efficiency-led productivity enhancement. Successful political and institutional reforms will be crucial for that.

Apart of studying cases of economies which can be suspected of falling into the middle-income trap, it is even more rewarding to examine strategies of those which managed to grow right through the hypothetical danger zone. In the case of South Korea, its export-led growth has since the 1960s been tied to the creation of internationally competitive industries on the ground. Backing of the financial sector and the government helped to overcome many hurdles and setbacks. Clearly, rushing through the middle-income phase is like growing rapidly into adulthood. It is not common but can be done.

Central Europe – at risk of the middle income trap

Central Europe lies within the range of the middle income trap, if we take it to mean the exhaustion of old sources of growth and inability to undertake a transition from efficiency-driven to innovation-driven model of development. The region’s success story is unquestionable. The Visegrad Four countries of Poland, Czech Republic, Slovakia and Hungary have a consolidated GDP of a trillion USD. This is four times more than in the mid-90s (260 billion USD). In terms of Purchasing Power Parity, the V4 are the 15th economy in the world. Germany trades more with them than with France and almost three times as much as with Russia. The substantial increase in labour and capital productivity over the years of the transformation was the most important engine of growth in the region.

Some of the trends surpised observers. Poland has overtaken Hungary which seemed unthinkable 20 years ago, although it is still the fifth poorest EU member state after Bulgaria, Romania, Hungary and Latvia (Lithuania edged slightly above Poland in 2011). The structure of the V4 economies remains very similar with a strong role of industry, from 31.1 percent of GDP in Hungary through 33.6 percent in Poland to 38.1 percent in the Czech Republic (2011 figures). Services constitute from 60.3 percent (Czech Republic) to 65 percent (Poland) of GDP. Net exports are key to growth across the region with the exception of Poland, where traditionally the higher domestic demand, particularly private investment, played more of a role.

Central Europe faces the prospect of slower growth for a number of reasons, including the ageing of the society, low levels of private investment and falling pace of productivity growth. The region is struggling to equip itself for the impact of demographic change by raising the retirement age. Numerous barriers to private investment linger on while the savings rate lags behind that of the region’s Western European peers. Raising productivity will require a comprehensive programme, including a reform of the university system.

Even in Poland, which has been the regional champion and has grown by over 15 percent since the beginning of the crisis in 2008, the Monetary Policy Council has recently pointed to the slowing of the potential growth due to the exhaustion of competitive advantages. World Economic Forum in its latest Global Competitiveness Report 2012-2013, ranks Central European economies in three different baskets. Bulgaria and Romania are in stage two of economic development, which is efficiency-driven. Estonia, Hungary, Latvia, Lithuania and Poland are „in transition“ from stage two to stage three which is innovation-driven. Finally, the Czech Republic, Slovenia and Slovakia are already in stage three, WEF concludes[4].

A somewhat different picture emerges when we look at the EU's Innovation Scoreboard. Only Estonia and Slovenia are ranked among „innovation followers“, countries whose performance is close to that of the EU27 average. Czech Republic, Hungary, Poland and Slovakia are among „moderate innovators“ with performance below that of the EU27 average. Finally, Bulgaria, Latvia, Lithuania and Romania are „modest innovators“, significantly below the EU27 average[5]. Two conclusions can be drawn from these rankings. First of all, the region is diverse while the performance of the individual countries differs extensively. Secondly, none of the countries is „on the other side of the river“ when it comes to anchoring in a high-productivity, innovation-driven economic model.

In the overall global competitiveness ranking, countries of the region are firmly in the middle ground. Estonia leads at 34th place (out of 144 countries ranked), down one since the year before. The Czech Republic is close behind at 39th position, also having slipped one place. Poland is third in the region with 41th place, unchanged from the year earlier. Lithuania is at 45th, Latvia at 55th (up from 64th), Slovenia at 56th, up from 57. Hungary underperforms at 60th and has slipped 12 places since 2011-2012. Finally, Bulgaria is at 62th place, up from 74th, Slovakia at 71st, down from 69th and Romania closes the regional ranking at 78th position, down from 77th[6]. Importantly, the region is not in a better position than the Southern European countries which are widely criticised for having lost competitiveness since entering the euro. Spain is at 36th position, only behind Estonia, Italy is at 42nd, just behind Poland, Portugal at 49th. Only Greece, at 96th place is clearly behind all of Central Europe.

As they navigate their countries to avoid the middle-income trap, the region's policy-makers need to be aware that competitiveness is a complex phenomenon for which there is no quick fix. It is not only labour costs which count but efficiency of the institutions, extensiveness of infrastructure, good macroeconomic environment, well-functioning health and education systems, efficient goods markets, developed financial markets, technological readiness, business sophistication or levels of innovation. It is only comprehensive action across this range of factors that can deliver results. The concept of the middle income trap, even if not flawless, can be helpful in focusing the minds and generating political support for the much-needed adjustment.

[4] The Global Competitiveness Report 2012-2013, World Economic Forum.

[5] Innovation Union Scoreboard 2011, European Commission.

[6] The Global Competitiveness Report 2012-2013, World Economic Forum.

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