SECTION 4

Middle-Income Trap

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The middle-income trap refers to a situation whereby a middle-income country is failing to transition to a high-income economy due to rising costs and declining competitiveness. Few countries successfully manage the transition from low to middle to high income. Many economies in Latin America and the Middle East regions have been stuck in a middle-income trap, "struggling to remain competitive as high-volume, low-cost producers in the face of rising wage costs" (World Bank 2010, 27). The hallmarks of success become binding constraints for these middle-income countries. Recent evidence suggests that a number of countries in East Asia are in a similar position. The following paragraphs outline the economic environment necessary to facilitate a convergence to a higher-income status, with examples of countries managing the transition and countries that are failing to manage it.

Evidence to support the middle-income trap indicates a leveling-off of income per capita and a decline or stagnation in an economy's competitiveness. Figures 4.1 and 4.2 illustrate the middle-income trap for middle-income economies in the East Asia region. Figure 4.1 shows gross domestic product (GDP) per capita for the Republic of Korea, Brazil, the Philippines, and the Syrian Arab Republic from 1950 to 2006. All countries "took off" in growth from the mid-1970s. Korea continued to grow throughout the 1980s,

achieving almost $8,000 income per capita in 2006. By contrast, the other economies leveled off over the period.

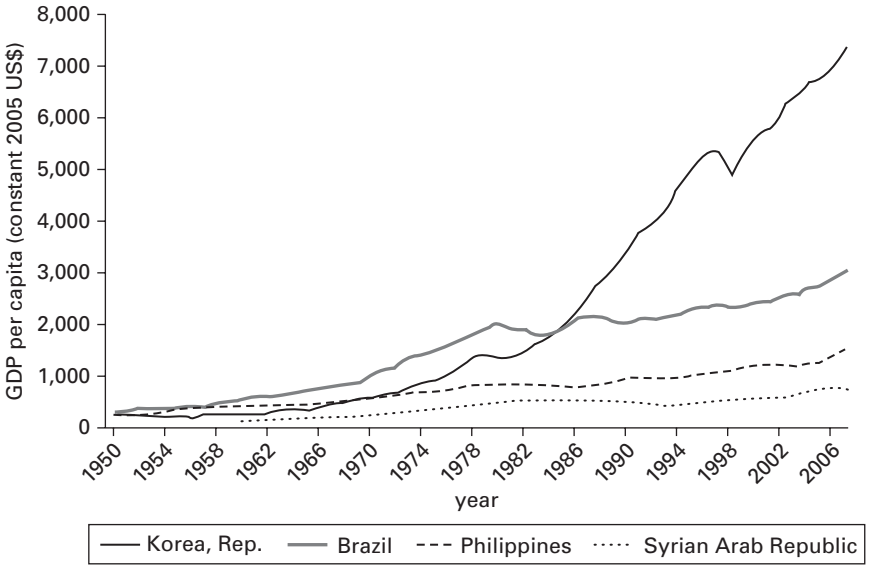
Figure 4.2 shows the competitiveness ranking for the middle-income economies of Malaysia, Thailand, Indonesia, and the Philippines beginning in 2000. All of the countries experienced stagnation in global competitiveness over the period to 2009.

Escaping from the Middle-Income Trap

At the minimum, a stable macroeconomic environment predicated on sensible fiscal, monetary, and regulatory policies is required. Furthermore, an economy with strong regional and global ties and with increasing urbanization is vital. Against this background, a number of ingredients are necessary to sustain the economy's growth and competitiveness and move it into the higher-income group. The World Bank (2010) identifies two key ingredients that comprise a number of others. These two overarching requirements are

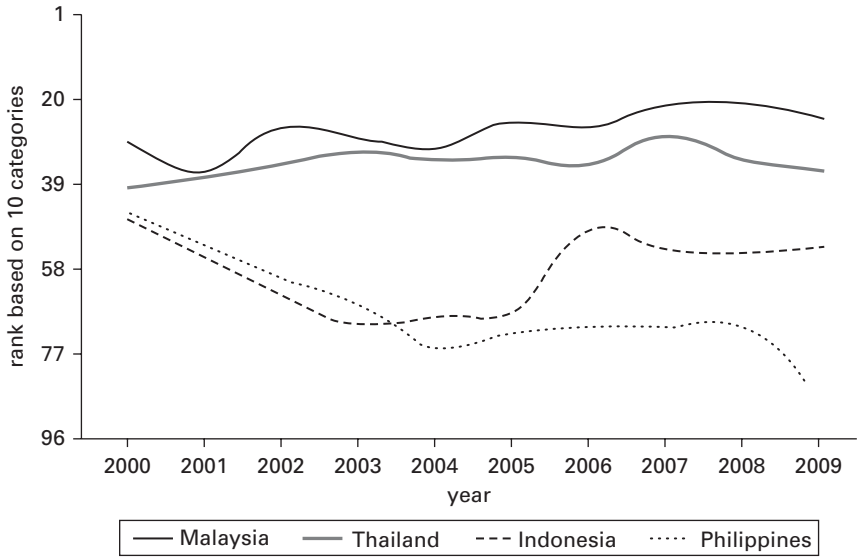
1. high levels of investment that embody new technologies, and
2. innovation-conducive policies.

Figure 4.1 Middle-Income Trap



Source: World Bank 2010, 27.

Figure 4.2 Global Competitiveness Indexes



Source: World Bank 2010, 27.

Sustained higher investment is critical for long-term growth. The Growth Commission suggested investment levels of 25 percent of GDP or more to achieve strong growth. Investment rates in Korea and Japan have averaged 31 percent since their respective takeoffs in 1978 and 1950. Financial crises negatively impact investment, and the challenge is to build on the recovery by investing in both human and physical capital. Areas that may provide immediate opportunities for investment include

- infrastructure—roads, housing, energy, and information technology;
- green technology; and
- public-private partnerships.

Transitioning to a high-growth economy requires a move up the value chain.[1] Innovation in new products and processes both in adoption and development as well as in business operation is critical in this regard. While the middle-income economies in East Asia are beginning from a good base, having absorbed foreign knowledge and thereby improved their production capabilities, much more needs to be done (World Bank 2010). In summary, a good innovation policy requires

- creating incentives for productive entrepreneurship;
- providing adequate skills to the workforce;
- ensuring good transmission of information and ideas; and
- making sure that financing is available for start-ups, upgrades, and commercialization (World Bank 2010, 33).

In Conclusion

Investment and innovation are the two key ingredients to moving a middle-income economy into a high-income economy. It is necessary to understand the macroeconomic factors that affect investment in each middle-income economy. At the macroeconomic level, capital flows through foreign direct investment can have a large impact on an economy's growth potential. Growth in Vietnam has been dominated by foreign-owned firms, and economic liberalization has been successful in making Vietnam regionally and globally integrated (Ohno 2009). However, to sustain growth and move the country onto a higher growth trajectory, three policies are required: (1) generation of internal value, (2) coping with new social problems caused by rapid growth, and (3) effective macroeconomic management under financial integration (Ohno 2009, 26). Furthermore, Yusuf and Nabeshima (2009) note that, although Malaysia was successful in attracting foreign direct investment in the electronics industry, it failed to generate domestic capability. Very few domestic firms entered the industry, despite incentives by local and regional governments. Firms that are unable to reach a certain threshold of capacity will not be able to take advantage of opportunities offered by globalization (Paus 2009). Paus attributes the failure of many middle-income countries in Latin America to escape the middle-income trap to this reason. An innovation-conducive policy that meets the requirements noted above is critical for future sustainable growth and moving an economy toward a higher growth frontier.

Note

1. Wu (2010) examines the issue of intellectual property rights in moving an economy toward the (world) technology frontier. Adopting intellectual property rights early in an economy's industrial development prevents a middle-income trap.

References

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