CONCLUSION

This report does not aim to provide a comprehensive overview of all of the issues related to economic development in middle-income economies. Indeed, it only touches on some of the challenges that these economies face in completing their transitions to high-income status and focuses specifically on the aspects of middle-income transitions that have changed over the years. While there is no evidence that the “middle-income trap” exists at a specific level of per capita income, middle-income transitions are challenging and often associated with lower growth in total factor productivity.

Our review of those economies that have performed best over several decades does not reveal a magic recipe for completing the middle-income transition. The geographic locations of the top performers are varied, as are the comparative advantages on which economies have been able to capitalise in the past. To paraphrase the opening line of Leo Tolstoy’s Anna Karenina, every middle-income economy is unhappy in its own way, with its unique challenges and obstacles to growth.

Yet several common themes emerge from our analysis. Having reached middle-income status, economies often need to adjust their economic development model. The new model typically needs to be more innovation-intensive. And as growth relies more on innovation, a healthy ecosystem of SMEs plays an increasingly important role in boosting economy-wide productivity. Consequently, growth in upper-middle-income economies depends more on improvements in the quality of the economic and political institutions.

Rethinking the development model also goes hand in hand with higher levels of investment in infrastructure, other physical capital and skills. These investments target the economy’s old capabilities and its new ones. The flipside of this investment requirement is a lower fraction of growth not attributable to increases in the stock of physical capital, human capital or labour. This results in lower growth being observed in total factor productivity at income levels between one-third and two-thirds that of the USA.

In this sense, the lessons learned from the successful middle-income transitions that started back in the early 1960s still apply: the importance of investment, domestic savings, skills and governance. In broad terms, economies in the EBRD regions tend to compare favourably with other economies at comparable levels of per capita income when it comes to skills and human capital. Yet they face a significant deficit when it comes to governance, in addition to major demographic headwinds.

Indeed, rapid changes in demographics and technology have been altering some of the policy priorities in middle-income economies. Over time, economic growth has become less reliant on manufacturing. At the same time, technological change has increased the extent of economies’ specialisation in particular segments of the value chain. It has also made knowledge-intensive services more tradeable across borders.

Technological change has also placed issues related to the distribution of income at the core of the policy debate in middle-income economies. In the past, the rising tide of convergence successes tended to lift all boats, allowing economies to pursue successful convergence strategies with relatively weak social safety nets. Today, much like the advanced economies, emerging markets are using automation to produce goods and services more cost effectively, particularly in those countries where populations are ageing and labour forces have started to shrink. As a result, middle-income occupations that often involve routine or clerical tasks have become exposed to automation, while the typical working life has become much longer, highlighting the challenge of retaining and upgrading one’s skills.

The combination of technological and demographic change requires a rethink of social safety nets in middle-income economies, based on affording protection to individuals rather than jobs — including unemployment benefits, portable pensions and mid-career retraining opportunities for workers. Without such reforms, the rise of populist politicians may undermine economy-wide governance — the key ingredient of successful middle-income transitions.

Another new challenge faced by middle-income economies is burgeoning pollution. Middle-income economies tend to be more polluting per unit of GDP than both low-income and high-income countries, largely down to their industrial structures and, in part, their use of less advanced technologies than those found in advanced economies. To make middle-income transitions greener, it is crucial to create the right incentives for firms. Too often, however, middle-income economies are slow to phase out energy subsidies. As a result, their firms — and, in particular, their best-managed firms — are more polluting than they could be given best available technologies.

Middle-income economies’ high investment needs mean considerable demand for finance. Evidence strongly suggests that the structure of finance is of utmost importance to the success of middle-income transitions. Equity finance, specialised venture capital-type instruments supporting young and innovative firms, the development of local-currency finance and the swift resolution of any build-up of non-performing loans in the banking sector, in particular, help economies to initiate and sustain periods of exceptionally strong growth. Developed equity markets also make growth greener.