FOREWORD

Around 5.5 billion people, or three-quarters of the global population, live in middle-income countries. The social and economic development of these countries matters to the whole world, as a source of human capital and savings and as a large market for exporters from both rich and poor nations. However, while middle-income countries continue to catch up with their advanced peers, they are not catching up as quickly as they did during their transition from low to middle income. Some have actually stopped converging.

The difficulties experienced by many countries in progressing to high-income status have fuelled the debate on the "middle-income trap", a concept first put forward in 2007 by then-World Bank economists Indermit Gill and Homi Kharas.[1] They argued that the development challenges faced in the transition from middle to high income were qualitatively different to those encountered by poor countries and that the further development of middle-income countries, therefore, required new growth models and new institutions. Countries that failed to reinvent themselves got stuck in "the middle-income trap".

Over the past decade, economists have studied the middle-income trap extensively. In quantitative terms, finding the "Holy Grail" – the exact "trap threshold", either in absolute income per capita terms or relative to the frontier – has been elusive. There is no simple measure for identifying the precise level of income at which countries need to reinvent themselves to avoid or escape the middle-income trap. In qualitative terms, however, the concept of needing to reform the development model at some intermediate level of income still holds. For every "trapped" middle-income country, economists can identify the reforms that should have been implemented. And for every successful middle-to high-income transition, we can point to the reforms that underpinned it.

The quintessential success story of such transformation is South Korea, which moved from low to middle income by capitalising on the might of large industrial conglomerates (chaebols). With the support of the government, the chaebols mobilised resources and coordinated the large-scale investment needed to industrialise a formerly backward economy. However, by the late 1990s, this growth model had outlived its potential, resulting in a major financial crisis in 1998.

South Korea did not "waste a good crisis", however. It seized the moment to restructure the chaebols, promote competition and innovation, and transform its industrial economy into a post-industrial, knowledge-based one.

Contrary to conventional wisdom, South Korea is not alone in its achievements. There are quite a few successful middle – to high-income transitions. In this report, we discuss what current "middlers" can learn from them. The recipe is well known, of course: good governance, competition, labour mobility, innovation, integration into the global economy, financial development, investment in human capital and sustainable infrastructure. Alas, there is no one-size-fits-all policy mix, but our analysis of past successes offers many useful takeaways for policymakers interested in breaking out from the middle-income trap.

While learning from the past, it is crucial to look to the future. Today's middle-income countries are facing a very different environment to that of their predecessors. The global economy is now much more open. Cross-border transportation, investment and trade costs are much lower. Skilled workers are far more mobile. Technological change promotes globalisation and this is reinforced by economic openness. Innovators are now competing for the global marketplace. This is an unprecedently large market and innovators' incentives to win market share are far stronger. Their resources are also much more scalable (due to cross-border flows of skills, ideas and capital). Not surprisingly, technological change is accelerating.

[1] See Gill and Kharas (2007).

This presents new challenges for today's middle-income countries. First, they are facing "premature de-industrialisation". In the past, development was about industrialisation (moving people from farms to more productive factories) followed by de-industrialisation (moving labour into high-skilled services). Thus, de-industrialisation has always been (and still is) an essential part of the middle – to high-income transition. Today, however, industry's share of GDP and employment is peaking at substantially lower levels than in the past. This means that middle-income countries have to create high-skilled service jobs at lower levels of development and, therefore, at a lower level of human capital. This premature de-industrialisation is, of course, an implication of globalisation and technological progress. In the past, industry would move from countries with high labour costs to poor or middle-income countries. Today, industry is staying in high-income countries, or even moving back to them, as automation reduces the need for cheaper labour.

Premature de-industrialisation leads to the second challenge: middle-income transition today relies more than ever on moving to a knowledge-based economy, fuelled by innovation and investment in research and development (R&D). This is harder to do in the modern world, where innovation and research are carried out by skilled workers who are increasingly mobile. Their wages are now driven by returns on their skills in the global, rather than the local, market. As we discuss in this report, empirical analysis shows that returns on R&D investment are highest in middle-income countries, implying rich opportunities, but also a dearth of such investment.

The third challenge, also related, is inequality. The march of globalisation and technological progress polarises the job market not only in advanced economies, but also in middle-income countries. Because of premature de-industrialisation and the difficulty of creating a sufficient number of highly skilled jobs, middle-skilled workers lose jobs and either move to the low-skilled segment of the labour market or leave the labour force altogether. A modern middle-income-transition policy mix should, therefore, include a focus on social safety nets and access to public goods for those without employment, as well as life-long upskilling and reskilling.

Fourth, many middle-income countries, especially those in the EBRD regions, are ageing rapidly. As the ratio of labour force to population shrinks, it is becoming harder and harder to lift per capita income. Advanced economies address this challenge through immigration, automation and longer working lives. Many middle-income countries, however, are seeing emigration and lag when it comes to automation. What's more, older cohorts of their populations cannot work as much as their peers in rich countries due to under-developed healthcare systems.

The fifth challenge is climate change. According to the environmental "Kuznets curve", it is the middle-income countries that may pay a higher price in terms of pollution. Poor countries are not as heavily industrialised as their middle-income cousins and rich countries, with their service-based economies, are already on a de-industrialising path. It is the middle-income countries that have a higher share of polluting industries. So, as the world strives to implement the Paris Agreement, middle-income countries will face a disproportional challenge. Fortunately, there are reserves to tap. Many middle-income economies still have substantial fossil-fuel subsidies. As these are removed, there will be greater incentives for companies to "green" their business models and additional resources for governments to support the green transition, in particular, by investing in sustainable infrastructure.

In addition to investment in skills, healthcare, R&D and sustainable infrastructure, middle-income transitions should be supported by financial development. Here, the main challenge is not just quantity, but also the structure, or quality, of finance. Most middle-income countries lack deep and broad equity markets. This is unsurprising, as (unlike debt) equity requires strong governance. On the flip side, if and when governance (at the national, local or company levels) is improved, equity markets will help resolve many of the challenges outlined above. The development of equity markets will promote innovation and the creation of knowledge-based sectors of the economy, help mitigate the social impact of ageing and even provide incentive for a green transition. Equity holders are long-term residual claimants on the value of corporate assets and it is in their interest to invest in assets that will not be stranded due to climate change or anti-climate-change regulation.

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