

OVERVIEW

Rapid transitions from low to high levels of per capita income – middle-income transitions – are challenging, as they require rethinking the development model and simultaneously investing in old and new economic capabilities. Nonetheless, economic history points to a number of successful transitions, such as that of South Korea. Over time, technology has altered the formula for success. Knowledge-intensive services can now be exported much like manufacturing products were in the past, while manufacturing employs fewer workers. Building social safety nets and making economic growth greener are increasingly important elements of middle-income transitions, while other ingredients have become even more crucial. Investment, for example, remains the single most important determinant of exceptional economic growth long term and is a function of quality of governance and skills. Simply throwing money at the problem does not seem to make a successful middle-income transition more likely, as the quality of finance plays an important role.

Many economies in the EBRD regions have reached or are approaching middle-income levels.² Since the global financial crisis of 2008-09, these countries have also experienced a marked slow-down in the rate at which their per capita income is converging on the level of advanced economies.

Could countries in the region become trapped in a cycle of weak growth at the middle-income stage of their development? And what can be learned from the history of successful (and less successful) transitions from low- to middle- to high-income status (known as the “middle-income transition”)?

Similar questions have been raised before. The term “middle-income trap” was originally coined in 2007 by Indermit Gill and Homi Kharas to refer to the marked slow-down in South-East Asia’s economic growth following the 1997-98 financial crisis.³ The question of whether such a trap exists at a specific level of income has been the subject of heated debate ever since.⁴

In this report, we revisit middle-income transitions around the world since the mid-1950s and make eight observations about these experiences that hold valuable lessons for middle-income economies today. These observations are mostly intuitive. Yet, there are important nuances that distinguish them from commonly held beliefs about the middle-income trap.

Careful examination of the data fails to identify a middle-income trap, as such, at a specific level of per capita income. Unsurprisingly, economic growth tends to slow as countries grow richer. Yet this is true for all levels of income (possibly with the exception of the poorest economies). A more nuanced pattern can be observed in total factor productivity – the residual in growth accounting that reflects the efficiency with which capital and labour inputs are combined to produce output.

Productivity growth tends to slow in countries where income is around one-third to three-quarters that of the USA, but it picks up again in the group of advanced economies. This is down to the structural transformation that middle-income economies have to undergo as they grow richer. In the early stages, economic development is primarily driven by the use of existing technologies and improvements in the efficiency of production. This is true for any sector, from basic textiles to smartphone assembly. Advanced economies, in contrast, generally enjoy a comparative advantage in terms of innovation and the design of global value chains. Within the same sectors, advanced

² In our analysis, we refrain from using specific income thresholds. If we define middle income as one-third to two-thirds of the income per capita of the United States of America (USA), we are talking about US\$ 20,000 to US\$ 40,000 at purchasing power parity (PPP) or market exchange rates as of 2018. In contrast, the World Bank defines upper-middle income as US\$ 7,650 to US\$ 19,800 at PPP.

³ See Gill and Kharas (2007).

⁴ See, for instance, Eichengreen et al. (2015).

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economies tend to design smartphones and organise the global supply chains that assemble them, or design high-brand apparel using fabrics produced in low-income economies.

The skill sets, industrial structures and institutions underpinning the two models – one of imitation-based development and one of innovation-based development – are fairly different.⁵ The switch between these models tends to occur at middle-income levels and is reflected in a temporary drop in the rate of productivity growth as economies develop new skill sets and retool themselves.

This makes the middle-income trap a useful concept, even if it cannot be pinned to a particular level of income that is hard to attain. Rather, it refers to the transformation of a country's economic development model that drives a change in its skill set and economic structures.

Successful middle-income transitions are relatively rare, but they do exist and are more diverse than commonly thought. Comparing economic performance across very different levels of income and several decades is notoriously difficult. In this report, we use a convenient metric that contrasts an economy's performance with that of similar economies, year by year, and calculates the extent to which an economy out-performs its peers over a number of years of sustained strong growth.

The “Asian Tiger” economies have been home to some remarkable transformations. For instance, South Korea outperformed the record of economic growth of its peers by about 850 per cent between 1961 and 2003. Yet, other economies that outperformed expectations by 350 per cent or more in a single episode of strong growth included Botswana, a couple of Caribbean Islands, the Maldives and oil-rich Oman. There is clearly no one recipe for successful middle-income transition in terms of sector focus or industrial policy. The comparative advantages exploited by successful economies varied significantly. What most of them had in common were improvements in governance, education and infrastructure that helped boost investment and productivity in the long term.

There are questions as to how much we can learn from the experience of successful middle-income transitions that have their roots in the early 1960s (as in the case of South Korea, Taipei China or Singapore). To explore the issue in more depth, we looked at the determinants of more recent episodes of sustained strong growth, including the decade since the global financial crisis of 2008-09, and compared them with the determinants of earlier spells of strong growth.

Our analysis reveals that while changes in technology and waves of globalisation affect middle-income transitions, the fundamental factors behind economic successes have remained broadly unchanged. Today, as before, investment and the availability of domestic savings to finance investment are the primary determinants of sustained strong growth, the length of the growth episode, the extent to which an economy can land softly, and its ability to avoid protracted crises and growth reversals. If anything, investment has played a greater role in post-crisis episodes of strong growth than in prior episodes.

While investment remains the key variable, it can and should be channelled to new areas. For instance, changes in technology have made manufacturing production more specialised along the value chain, but have also made knowledge-intensive services more tradeable across borders. And while technologies have evolved, the fundamental recipe for leveraging growth-enhancing investment – governance, skills and infrastructure – has changed little, if at all.

The positive relationship between income per capita and the quality of governance, in particular, is strong. Moreover, as incomes rise, economic development becomes more governance-intensive, as good governance underpins innovation

⁵ See also EBRD (2014) for a discussion with applications for the EBRD regions.

ecosystems. For economies in the EBRD regions, improving governance is a particular challenge: currently, they tend to have lower-quality economic institutions than other emerging markets with similar income levels.

In a globalised world, economies may need to fine-tune their development models more frequently than in the past. As economies develop, the employment share of agriculture declines and the share of services rises. The share of manufacturing rises initially, before reaching a peak and starting to decline. The peak in the manufacturing share of employment occurs at an ever-lower level, however. When economies reach their peak manufacturing employment points, their levels of income per capita, expressed as a percentage of that of the USA, tend to be lower than in the past. This regularity, dubbed “premature deindustrialisation”, is often portrayed as a major headwind to development that may deepen the middle-income trap. However, it may also present an opportunity to invest in new areas, such as knowledge-intensive services, tourism or the green economy,⁶ and leapfrog certain stages of development associated with building large industrial sectors and supporting infrastructure.

“Premature de-industrialisation” does have implications for income distribution in middle-income economies, though. Although manufacturing employment peaks at an ever-lower level of total employment, the manufacturing share of value added in gross domestic product (GDP) tends to decline much more slowly as economies develop further. This is because emerging markets also take advantage of automation to produce goods and services more cost effectively. In developing economies, much as in their advanced counterparts, middle-income occupations that often involve routine or clerical tasks are most vulnerable to automation.

In the past, the rising tide of convergence success tended to lift all boats. Consequently, economies could pursue successful convergence strategies with relatively weak social safety nets (as in the case of China, for instance). Often, social protection would only be strengthened once economies had achieved higher levels of per capita income. Moreover, large corporations would often be major providers of social security. As the sharing/platform economy disrupts traditional corporation-based business models, the approach to social security in middle-income transitions may have to change.

In addition, low- and middle-income economies have tended to enjoy a significant demographic dividend thanks to young and fast-growing labour forces. This is also changing apace.⁷ In emerging Europe, for instance, populations are ageing fast and labour forces are shrinking in many countries. The region’s economies are getting old before they can get rich.

A combination of technological and demographic change requires a rethink of the social safety nets in middle-income economies. The key feature of the new approach is affording protection to individuals rather than jobs – including unemployment benefits, portable pensions and mid-career retraining opportunities. The absence of social safety nets in the face of a rapid “hollowing of the middle” in the jobs market risks feeding populism and short-termism. This could, in turn, undermine economic and political institutions and jeopardise investment – the key drivers of middle-income transitions.

What is often perceived as a conflict between faster growth and social safety nets may, however, be a trade-off only in the short run. In the longer run, without broader societal consensus, growth-promoting economic policies may prove impossible to sustain in the face of brisk technological and demographic change.

Some policies can boost growth prospects while also strengthening equality of opportunity in an economy. For instance, improving infrastructure connections to relatively disadvantaged regions boosts trade, both domestic and international. A study of large-scale coordinated upgrades to Turkey’s road infrastructure in 2006-15, for example, found that better transport infrastructure had considerable effects on domestic trade. Moreover, as better roads improve economic opportunities in poorly connected regions, employment increases and outward migration declines, contrary to the belief that better transport links might facilitate an exodus from less developed regions.

Municipal infrastructure is another example of ultra-long-term investment that can boost growth and equality of opportunity. It helps to create a clustering effect, the agglomeration of people and ideas needed to boost productivity growth in many sectors of an economy. It also shapes a country’s environmental footprint and people’s livelihoods for centuries to come.

The change in economic model at the heart of middle-income transitions is also reflected in the way that firms enter the market, grow and cease to exist. In general, firms in middle-income

⁶ See Fankhauser and Kotsch (2018) and Martin (2019) for a discussion of green-economy potential in the EBRD region.

⁷ See EBRD (2018).



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economies tend to be less productive than firms in advanced economies. This is unsurprising, as differences in productivity of individual enterprises lead to differences in per capita income. Economic convergence is essentially about boosting the productivity of firms.

As countries develop, large enterprises, sometimes referred to as “national champions”, may deliver fast growth and improvements in productivity.⁸ These enterprises often excel at importing existing technologies, leveraging economies of scale and penetrating export markets – with or without the support of the state. Yet, they seldom excel in innovation on a global scale.

As growth becomes more innovation-intensive, the healthy ecosystem of small and medium-sized enterprises (SMEs) plays an increasingly important role in supporting economy-wide productivity growth. The success of SMEs is also key to broadening the distribution of wealth generated by economic convergence, thus helping to avoid an excessive rise in income inequality.

Small is not necessarily beautiful in middle-income economies, however. On average, small firms tend to be less productive than large firms. This is to be expected: very productive small firms should be able to grow fast, gain market share and become large, contributing to the productivity growth of the economy overall. However, small firms in middle-income economies are often particularly unproductive. Small firms in emerging Europe, for instance, tend to be far less productive than their counterparts in advanced economies, such as Germany. The difference between the productivity of large firms in the EBRD regions and large German firms is far smaller. There also appears to be a tenuous link between the productivity of small firms in emerging Europe and their likelihood of growing or shrinking.

Regulations and poor governance often create perverse incentives for firms to stay small. Sometimes this is because larger firms are subject to much more onerous regulation in an attempt to protect jobs and create employer-based social-security nets. In other cases, rent-seeking and predatory behaviour by the authorities can prompt firms to try to remain “under the radar”. Whatever the cause, completing the middle-income transition is reliant on institutional improvements that can strengthen dynamism among small and medium-sized companies.

Another major challenge faced by middle-income economies is rising pollution. As economies develop, they tend to industrialise before they can strengthen their comparative advantage in low-

pollution sectors, such as knowledge-intensive services. The result is the environmental “Kuznets curve”, whereby middle-income economies become more polluting per unit of GDP than both low-income and high-income countries. Just as they need to give SMEs a leg up, countries need to create the right incentives for firms to pursue energy savings and make growth greener.

Studies find that markets are good at responding to incentives, but firms, somewhat cynically, will respond to both incentives to modernise their production and incentives to remain backward. In countries where energy consumption is strongly subsidised, better-managed firms are significantly less energy efficient. They emit more greenhouse gases per unit of sales as good managers seek to exploit energy subsidies provided by the government. In countries with few or no energy subsidies, better-managed firms are up to 30 per cent more energy efficient than their poorly managed counterparts.

Many problems can be solved by throwing enough money at them, but evidence suggests that in the case of middle-income transitions, the structure (or quality) of finance is particularly important. In the early stages of development, finance is a critical ingredient of growth. It helps entrepreneurs bring their ideas to market and speeds up the accumulation of physical and human capital.

In recent years, there has been growing concern about over-indebtedness in middle-income economies. Corporate debt in large emerging markets as a percentage of GDP now exceeds that of companies in advanced economies. Further analysis shows that higher private-sector credit as a percentage of GDP can lower the likelihood of exceptionally strong growth and make poor performance more likely. This relationship actually predates the global financial crisis.

The depth of equity markets exhibits a strong positive correlation with robust growth. It is also associated with lower greenhouse gas emissions across industries and countries, while higher levels of debt finance lead to rising emissions. In part, this is due to the propensity of banks to invest in older, tested technologies. Equity, in contrast, is more likely to plump for innovative, forward-looking ideas, both through stock markets and specialised instruments, such as private equity or venture-capital funds.

The provision of longer-term finance and finance in local currency further reduces the vulnerability of middle-income

⁸ See Chang (2011) for a discussion and examples from various countries.

economies to external shocks. In countries where non-performing loan levels are high, swift resolution can pay a substantial growth dividend. Overall, middle-income economies are less dependent on the availability of finance than commonly thought, but the structure of finance plays a key role in shaping their growth trajectories.

In sum, middle-income transitions are challenging. At this stage in their economic development, countries need to rethink their economic model. Economies need to maintain investment in existing capabilities while simultaneously investing in new ones. Notwithstanding these challenges, several countries – notably South Korea – have succeeded in rapidly transitioning from low to relatively high levels of per capita income.

Over time, technology has altered some of the ingredients of such success. Today, for example, knowledge-intensive services can be exported in much the same way as manufactured products, while manufacturing employs fewer workers than it did a few decades ago. Building social safety nets and making economic growth greener have become increasingly important elements of middle-income transitions.

Yet, other ingredients of successful middle-income transitions have grown in importance, too. Investment, for instance, remains the single most important determinant of exceptional growth performance over the long term. High investment, in turn, relies on good governance and quality skills. And when it comes to financing sustained growth in middle-income economies, the way in which finance is structured matters.

BOX 1. Eight facts about middle-income transitions

- 1.** The “middle-income trap” is about rethinking a country’s economic development model rather than overcoming a particular level of income.
- 2.** Successful middle-income transitions, such as South Korea’s, are relatively rare, but they are far more geographically diverse than commonly thought.
- 3.** The factors behind “growth miracles” change over time, but not always in the way they conform to stereotypes. Investment remains the key ingredient, even if technology changes its focus. In turn, productive investment requires good governance, strong skills and quality infrastructure.
- 4.** In the past, middle-income transitions were possible without due attention to building social safety nets. In the future, this will change.
- 5.** Beyond boosting growth, investment in infrastructure helps to improve equality of opportunity.
- 6.** Predictably, firms in middle-income economies are less productive than their advanced-economy counterparts. However, the relative productivity gap is greater for small firms than for large enterprises.
- 7.** Middle-income economies are high polluters, a reflection of the distorted incentives firms often face.
- 8.** Finance matters to middle-income transitions – particularly the way, in which it is structured.