

PERSPECTIVE

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APEC and the Middle Income Trap

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EXECUTIVE SUMMARY²

- The Middle Income Trap has come to dominate headlines and policy discussions in the Asia-Pacific. Recent research suggests that growth past a certain threshold requires a qualitative ‘shift’ as economies transition from labour- and capital-intensive growth to productivity- and technology-driven growth. However, while more and more countries have attained middle income levels, very few have been able to grow past this to reach high income status.
- The Middle Income Trap is an important topic for APEC. It is of concern to the grouping’s nine developing member economies, all of whom are middle income. It is also these large and dynamic countries who are slated to contribute the most to growth in the future. The topic is a rare theme of common interest that can bring together the organization’s members from Asia and Latin America.
- That said, given APEC’s diverse membership, ‘light’ institutionalization, and limited resources, it is worth asking if the organization can make a significant contribution. This Perspective argues that it can for three reasons.
 - First, the organization’s strength in technical policy dialogue is what is needed to promote the painstaking, piecemeal reforms in trade, investment, and business legislation needed to boost productivity and innovation.



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- Second, APEC’s diversity of members is a strength, as it brings together a range of dynamic emerging economies with a number of mature economies – many of whom are already linked through production networks.
- Third, the private sector, which is incorporated in the organization’s structure, can also play a key role in providing input.
- However, beyond its current focus on structural reform, APEC should also consider boosting its economic and technical cooperation activities in manufacturing best practice, which has been key to the rapid growth of the region’s highest-performing economies.

INTRODUCTION

The Middle Income Trap has been discussed extensively in the Asia-Pacific over the last few years. At the highest levels in Malaysia, China, and Vietnam, policy-makers have been asking for the best way to move from labour- and capital-intensive growth to productivity- and technology-driven growth. Responding to this policy need, organizations such as the World Bank, the Asian Development Bank, and the Organization for Economic Cooperation and Development (OECD) have sought to attain thought leadership on this issue.

APEC has also begun to discuss the Middle Income Trap. China, the organization's previous Chair, brought up the issue in 2014. Following instruction from the Leaders in November last year, APEC's Economic Committee has included it as a topic under its Structural Reform Programme. The Philippines, the current Chair, has also maintained the Middle Income Trap as a topic, and more detailed directions on future work will be given at the Leaders' Meeting in Manila in November.

The term 'Middle Income Trap' has a lot of resonance for countries in the region, many of whom have either languished in middle-income status for extended periods of time, or are worried about growth slow-downs. However, while the concept has been successful at attracting the attention of policy-makers, it has also given rise to a plethora of different definitions, methods of measurement, and countries that it is taken to refer to. Beyond the validity of the concept itself, it is worth asking if this is an area where APEC can make a useful contribution, given its unique organizational characteristics.

THE ORIGINS OF THE DEBATE

The Middle Income Trap has been discussed in various forms for a little over a decade. In 2004, Garrett wrote about globalization's 'missing middle'.³ He argued that globalization processes have benefited wealthier countries whose institutions and human capital bases encourage innovation, as well as poorer nations who focus on routine tasks and utilize easily available technology at low costs. However, countries in the middle, with higher labour costs and imperfect institutional configurations, have not benefited as much. Trapped between countries at the technological frontier such as United States on one hand and low-cost providers such as China on the other, he argued that middle income countries were faced with decreasing opportunities.

In their 2007 work, *An East Asian Renaissance*, Gill and Kharas develop this further.⁴ They argue that a number of middle income countries in East Asia could potentially attain high income status. However, in order to do that, they must seek to alter the way they do things. In particular, this group of countries needs to: become more specialized in terms of what they produce; shift from investment-driven to innovation-driven growth; and produce skilled and creative workers. Should this not occur, these aspiring countries will be 'squeezed between the low-wage poor-country competitors that dominate in mature industries and the rich-country innovators that dominate in industries undergoing rapid technological change'.

³ Garrett Geoffrey. "Globalization's missing middle". *Foreign Affairs* 83 no.6 (2004): 84-96.

⁴ Gill, Indermit and Homi Kharas. *An East Asian Renaissance: Ideas for Economic Growth*. Washington, D.C.: The World Bank, 2007.

However, while intuitively appealing, this is not an uncontested concept. *The Economist* famously labelled the issue as ‘claptrap’, arguing that policies should just focus on leveraging a country’s comparative advantage.⁵ The periodical contends that competitiveness is not a dichotomy of labour-intensive or skill-intensive activities, but that economies operate along a continuum and competitiveness is determined at a given price point. Furthermore, the transition from factor-intensive to knowledge-intensive production is a continuous process, rather than a disruptive one.

While this position has considerable merit, it is hard to argue with one statistic. According to the World Bank, since 1960 only 13 out of 101 countries classified as middle income have subsequently been able to attain high income status. In East Asia, this group is limited to Japan, South Korea, Taiwan, Hong Kong, and Singapore.⁶

Thus, if simply focussing on a given country’s comparative advantage were sufficient for growth to occur, and the transition from factor-intensive to knowledge-intensive production were continuous, surely more countries would have ‘graduated’ to high-income status over the past five decades? The fact that only a small minority have done so suggests that this process is not automatic, and that growth past a certain threshold is more difficult.

DEFINING THE MIDDLE INCOME TRAP

There are, broadly, two ways of defining the Middle Income Trap. First, one can use international income standards to identify those countries who classify as middle income and then specify thresholds or performance indicators that indicate whether they have ‘graduated’ to high income levels or have failed to do so – thus falling into a ‘trap’. Alternatively, one can look at countries seeking to transition away from labour- and capital-driven growth to productivity- and technologically-growth and analyse the policy challenges they face.

Felipe et al look at the pace at which countries grow and move from one income category to the other.⁷ They identify four groups by GDP per capita: low income; lower middle-income; upper middle-income; and high-income.⁸ Based on cross-country comparisons, and particularly the trajectory of high-performing economies, Felipe et al then specify how long a given country should take to pass from middle to high income. Those countries that are unable to ‘graduate’ to high income within this time frame are taken to be in the middle income trap.

⁵ *The Economist*, “Middle Income Claptrap: Do Countries get trapped between Poverty and Prosperity?” February 16, 2013.

⁶ World Bank. *China 2030: Building a Modern, Harmonious and Creative Society*. Washington DC: World Bank and the Development Research Centre of the State Council, 2013.

⁷ Felipe, Jesus, Arnelyn Abdon, and Utsav Kumar. “Tracking the Middle Income Trap – What is it, Who is in it and Why?”. *Working Paper Number 715*, Levy Economics Institute of Bard College, 2012.

⁸ A variant of this approach is to look at income relative to a frontier economy, usually the United States. Lee, Keun. *Schumpeterian Analysis of Economic Catch-Up: Knowledge, Path-Creation, and the Middle-Income Trap*. Cambridge: Cambridge University Press, 2013.

Along a similar vein, Eichengreen et al argue that the middle income trap can be understood as a slow-down in growth after a specific threshold.⁹ Defining a slow-down as a decrease in growth of at least 2 percent over two consecutive and non-overlapping seven-year periods, they examine episodes of slow-downs in previously rapidly growing middle-income economies. They find that, rather than one point, there are two where growth slow-downs are more frequent – one at approximately US\$10-11,000 per capita and another at US\$15-16,000 per capita (in 2005 PPP dollars).

The other approach is to focus on the structural issues that middle income economies face in their transition towards higher value-added activities. Thus, the World Bank and Asian Development Bank relate the Middle Income Trap to the challenges inherent in moving from labour- and capital-intensive growth to productivity- and technology-driven growth.¹⁰ In similar fashion, the OECD refers to the transition from ‘intrinsic’ based on factor-driven growth to ‘extrinsic’ or productivity-driven growth (2013, p. 279).¹¹

Ohno breaks this process down further. Looking specifically at industrialization, he argues that there are four consecutive stages that countries need to pass through to attain high income status.¹² These are a) simple manufacturing under foreign guidance; b) the development of indigenous supporting industries, but still under foreign supervision; c) the local acquisition of leading-edge technology and management practices and d) full indigenous capability in innovation and product design.

According to this classification, Vietnam is at the first stage; Malaysia and Thailand are at the second; Korea and Taiwan are at the third; and Japan, the United States and the European Union are at the fourth. Ohno argues that the transition from the second to the third stage is very difficult, and has been a ‘glass ceiling’ for all Southeast Asian and many Latin American countries. It is this inability to fully master the technology and management techniques necessary for the production of high quality goods that constitutes the middle income trap.

HOW TO ESCAPE THE TRAP

For much of the recent past, economic policy-making has looked at escaping the poverty trap. In 1950, a full 70 percent of the world’s population lived in countries that were classified as poor. It was thus appropriate that attention focus on kick-starting growth and creating jobs. However, by 2010, this proportion had shrunk to 36 percent, meaning that the bulk of the world’s population now lives in countries that are lower middle-income or above.¹³

⁹ Eichengreen, Barry, Donghyun Park and Kwanho Shin. “Growth Slowdowns Redux: New Evidence on the Middle Income Trap”. NBER Working Paper 18673, Cambridge: National Bureau of Economic Research, 2013.

¹⁰ ADB. *Asia’s Economic Transformation: Where to, How, and How Fast?* Mandaluyong City: Asian Development Bank, 2013; Commission on Growth and Development. *The Growth Report: Strategies for Sustained Growth and Inclusive Development*. Washington D.C.: The World Bank, 2008.

¹¹ OECD. *Economic Outlook for Southeast Asia, China, and India 2014: Beyond the Middle Income Trap*. Paris: Organization for Economic Cooperation and Development, 2013.

¹² Ohno, Kenichi. *The Middle Income Trap: Implications for Industrialisation Strategies in East Asia and Africa*, GRIPS Development Forum, 2009 (<http://www.grips.ac.jp/forum/pdf09/MIT.pdf>; accessed on 16 July 2015).

¹³ Pelkmans-Balaoing, Annette. *The Middle Income Trap: A Challenge for Competitiveness and Inclusiveness*. Seminar on the Middle Income Trap (APEC Senior Officials Meeting), 15 May, 2015, Boracay.

In these cases, the industrialization process is underway or established, some sectors are integrated into regional production networks, pockets of expertise have emerged, and inroads have been made into key overseas markets. The issue facing these countries is no longer about escaping poverty, but rather the appropriate institutional and policy settings to enable them to continue to grow.

The experience of the high-performing Asian economies of Japan, Korea, Taiwan, Singapore, and Hong Kong provides useful insight into the nature of this transition, often referred to as *structural transformation*. It has various components, including: shifting capital and labour to more productive sectors such as manufacturing and services; the increasing sophistication of production and export ‘baskets’ underpinned by deepening capabilities and diversification of products; and the use of more efficient methods of production.¹⁴ While services can be important drivers of growth, in-depth research into these economies highlights the importance of manufacturing in underpinning a shift to productivity- and technology-driven growth. Indeed, no country has reached high-income status without a strong manufacturing sector employing approximately a fifth of the workforce.¹⁵

Furthermore, exports constitute an important part of this process, with firms being exposed to competition, global best practice, and generate scarce foreign exchange.¹⁶ In addition, what firms produce also matters. A consistent finding is that countries with firms that produce more sophisticated and diversified exports are more likely to grow quickly and are less likely to experience growth slow-downs. When matched with income level, this relationship is particularly robust for middle income countries.¹⁷

However for the manufacturing and services sectors – and particularly more value-added niches within them – to develop, firms need an enabling environment. The first and most basic is a range of market-supporting institutions that provide a minimum level of: property rights; regulation; macro-economic stability; social protection; and conflict mediation.¹⁸ In addition, openness to trade and investment is vital to allow local firms to access overseas markets, be exposed to competition, and procure inputs and technology as well as capital.¹⁹

That said, at lower income levels, a country can progress quickly with ‘second best’ institutions. This refers to contexts where market and government failures that cannot be eliminated in the short run are bypassed through alternative arrangements. This can take the

¹⁴ ADB. *Asia’s Economic Transformation: Where to, How, and How Fast?* Mandaluyong City: Asian Development Bank, 2013.

¹⁵ ADB. *Asia’s Economic Transformation: Where to, How, and How Fast?* Mandaluyong City: Asian Development Bank, 2013. This supported by Bulman, David, Maya Eden, and Ha Nguyen. “Transitioning from Low-Income Growth to High-Income Growth: Is there a Middle Income Trap?” World Bank Policy Research Working Paper No. 7104. Washington DC: World Bank, 2014.

¹⁶ Ramanayake, Sanika Sulochani, and Keun Lee. "Does openness lead to sustained economic growth? Export growth versus other variables as determinants of economic growth." *Journal of the Asia Pacific Economy* 20, no. 3 (2015): 345-368.

¹⁷ Hausmann, Ricardo, Jason Hwang, and Dani Rodrik. “What you export matters.” *Journal of economic growth* 12, no. 1 (2007): 1-25; Bulman et al “Transitioning from Low-Income Growth”; Felipe et al “Tracking the Middle Income Trap”; Eichengreen et al “Growth Slowdowns Redux”.

¹⁸ Rodrik, Dani. *One Economics, Many Recipes: Globalization, Institutions, and Economic Growth*. Princeton: Princeton University Press, 2007.

¹⁹ Dollar, David. "Outward-oriented developing economies really do grow more rapidly: evidence from 95 LDCs, 1976-1985." *Economic development and cultural change* (1992): 523-544.

form of some form of protection from external competition for local entrepreneurs as well as preferential access to credit.²⁰

However, at higher income levels, these distortions must be eliminated, otherwise they will become a drag on growth. In addition, there is a growing body of evidence that countries need different institutional contexts and policy frameworks at different income levels. At its base, the difference seems to be whether firms are growth based on the *adoption* of existing technologies or by *innovating* themselves.²¹

Once a country is closer to the technology frontier, it is vital that the institutional context: enables firms to enter and exit markets easily; allows capital to be freely available and cater to smaller firms active in new sectors; and avoids stifling regulation and oversight. In particular, firms need to be allowed shut down if they are not competitive, enabling resources to be deployed more efficiently.²²

Quantitative research based on cross-country regressions finds that at upper-middle and higher income levels, total factor productivity becomes much more important than at lower or lower-middle income levels, suggesting a qualitatively different type of growth – such as that dependent on a higher-skilled work-force, deeper research capabilities, and more efficient business environments.²³ Furthermore, at the upper middle and higher income levels, greater provision of tertiary education as well as support for research and development are found to be correlated with higher rates of economic growth. In contrast, these are not significant in lower and lower-middle income countries, where secondary education is found to be more important.²⁴

Thus, while it can be argued that escaping the Middle Income Trap merely attests to the need to maintain growth momentum, there are reasons to believe that once a country has progressed beyond low income status, it needs to start looking at ways of producing more diversified and complex products. This, in turn, requires a distinct environment for firms, as well as different sorts of policies and spending priorities.

²⁰ Rodrik, Dani. *Second-best institutions*. NBER Working Paper 14050. Cambridge: National Bureau of Economic Research, 2008.

²¹ Acemoglu, Daron, Philippe Aghion, and Fabrizio Zilibotti. “Distance to frontier, selection, and economic growth.” *Journal of the European Economic association* 4, no. 1 (2006): 37-74.

²² Acemoglu, Daron, Philippe Aghion, and Fabrizio Zilibotti. “Distance to frontier, selection, and economic growth.” *Journal of the European Economic association* 4, no. 1 (2006): 37-74; IMF. *Regional Economic Outlook: Asia and Pacific*. Washington DC: International Monetary Fund, 2013.

²³ Bulman, David, Maya Eden, and Ha Nguyen. “Transitioning from Low-Income Growth to High-Income Growth: Is there a Middle Income Trap?” World Bank Policy Research Working Paper No. 7104. Washington DC: World Bank, 2014. Total Factor Productivity is the proportion of output not accounted for by labour or capital – it is taken to be an indicator of an economy’s technological dynamism.

²⁴ Lee, Keun, and Byung-Yeon Kim. “Both institutions and policies matter but differently for different income groups of countries: Determinants of long-run economic growth revisited.” *World Development* 37, no. 3 (2009): 533-549.

APEC AND ITS ROLE

At the highest level, APEC's goals and activities fit remarkably well into the Middle Income Trap debate. The organization's declaration states that it is committed to 'sustain the growth and development of the region' and 'enhance the positive gains of economic interdependence'.²⁵ Furthermore, its work is centred on three very relevant aspects: trade liberalization and facilitation; investment liberalization and facilitation; and economic and technical cooperation.

In addition, the Middle Income Trap is a topic crucial to an important constituency in the organization. Of its 21 member economies, nine are currently classified as middle income. Five are upper middle-income (China, Malaysia, Thailand, Mexico and Peru); and four are lower middle-income (Indonesia, the Philippines, Vietnam, and Papua New Guinea).²⁶ Following the tenures of China and the Philippines, the Chair will rotate to Peru, Vietnam, and Papua New Guinea, ensuring that this topic remains at the top of the agenda for the next while.

The success of these economies is of key interest to the Asia-Pacific region, as well as APEC itself. Should income disparities increase between its member economies, the commitment to trade and investment liberalization could be undercut. In addition, looking ahead, the large and dynamic economies of China, Indonesia, Malaysia, Thailand, and Vietnam are expected to contribute very significantly to global growth – if they are able to transition towards productivity and technology-driven growth.²⁷

And it is in these countries that this issue is keenly felt. Although China has averaged growth rates of 10 percent p.a. since 1980s, its economy's momentum has decreased of late, falling to under 8 percent p.a. in 2011-14. And while the Southeast Asian Tigers of Indonesia, Malaysia, and Thailand have also experienced good growth that has not been at the levels seen prior to the Asian Financial Crisis.²⁸ In addition, relative to middle income countries in other parts of the world – and particularly the high-income economies of Japan, Korea, and Taiwan – innovation levels in the middle income countries of Asia are below par.²⁹ There are also concerns about the availability and quality of human capital in China and key Southeast Asian economies.³⁰

²⁵ Seoul APEC Declaration 1991, available at http://www.apec.org/Meeting-Papers/Ministerial-Statements/Annual/1991/1991_amm/annex_b_seoul_apec.aspx, accessed 27 August, 2015.

²⁶ World Bank, New Country Classifications, 2015 available at: http://data.worldbank.org/about/country-and-lending-groups#Lower_middle_income [accessed on 8 August 2015].

²⁷ ADB. *Asia 2050: Realising the Asian Century*. Mandaluyong City: Asian Development Bank, 2011.

²⁸ World Development Indicators Online.

²⁹ World Bank. *Robust Recovery, Rising Risks: East Asia and Pacific Economic Update 2010 Vol. 1*, Washington DC: World Bank, 2010.

³⁰ Fang, C., & Yang, D. "The changing demand for human capital at China's new stage of development" in *Human Capital Formation and Economic Growth in Asia and the Pacific*, edited by Wendy Dobson. New York: Routledge, 2013; Raya, U. R. and Daniel Suryadarma "Human Capital and Indonesia's Economic Development" in *Human Capital Formation and Economic Growth in Asia and the Pacific*, edited by Wendy Dobson. New York: Routledge, 2013; and Jimenez, E, Vy T. Nguyen, and Harry A. Patrinos, "Human capital development and economic growth in Malaysia and Thailand: stuck in the middle?" in *Human Capital Formation and Economic Growth in Asia and the Pacific*, edited by Wendy Dobson. New York: Routledge, 2013.

The Middle Income Trap is also of concern across the Pacific. Unlike their Asian counterparts who have been growing quickly and are worrying about a potential growth slow-down, Mexico and Peru have been grappling with the Middle Income Trap for three decades. Following high levels of growth during the 1960s and 1970s, these two countries stagnated during the 1980s and 1990s, and also have issues with innovation, human capital, and producing higher value-added products.³¹

However, APEC, unlike the World Bank or Asian Development Bank, does not have an extensive loan portfolio. Nor, like the OECD, does it have a large bureaucracy with in-depth research capabilities. Its membership is very diverse and its organizational set-up is lightly institutionalized, relying on self-enforcement and lacking means of ensuring compliance. Furthermore, the organization has been criticized for pursuing too many topics and having an under-funded economic and technical cooperation (ECOTECH) pillar.³²

That said, the organization has a good record for policy dialogue and sharing of best practice, which is most evident in APEC's consistent work in the area of trade facilitation.³³ This non-glamorous and piecemeal work involves streamlining customs procedures, improving legislation to enable firm creation, and other measures to improve ease of doing business. Furthermore, ministries from across government participate in meetings – not just those related to foreign affairs or trade. This is vital for long-term reform. And, it is these small steps in the overall economic context which are likely to enable greater efficiency and productivity, and where many of the organization's middle income members need to make greater strides.

Furthermore, policy dialogue and sharing of best practice on productivity- and technology-driven growth is also one area where APEC can leverage on its unique membership structure. In addition to the high-performing economies of Japan, Korea, and Singapore, APEC is one of the few international organizations that counts Hong Kong and Taiwan among its members. While Hong Kong has interesting insights in the financial sector, it is Taiwan that can provide important insights. Its robust small and medium enterprise sector is among the world's most dynamic and innovative, and has made the most inroads in fostering local technological capabilities – particularly in the manufacturing sector. This is key to structural transformation and is an area where countries such as Malaysia, Thailand, and Indonesia have struggled mightily.

Furthermore, through APEC's structured mechanisms of dialogue with the private sector, the organization is particularly suited for this type of long-term capacity-building. The APEC Business Advisory Council (ABAC), the organization's private sector body, has been the promoter of many important initiatives, including the APEC Business Travel Card and the Free Trade Area of Asia and the Pacific.³⁴ Given the dense production networks that already link Japan, Korea, Taiwan, and the United States with other APEC member economies, ABAC should be in an excellent position to foster interchange.

³¹ OECD. *Perspectivas Económicas de América Latina 2015: Educación, Competencias e Innovación para el Desarrollo*. Paris: Organization for Economic Cooperation and Development, 2015.

³² Yamazawa, Ippei. *APEC: New Agenda in Its Third Decade*. Singapore: Institute of Southeast Asian Studies, 2012.

³³ Gyngell, Alan and Malcolm Cook. "How to Save APEC?" Policy Brief, October. Sydney: Lowy Institute, 2005.

³⁴ Yamazawa, Ippei. *APEC: New Agenda in Its Third Decade*. Singapore: Institute of Southeast Asian Studies, 2012.

At present, APEC has incorporated the Middle Income Trap under its Structural Reform programme, which seeks to improve the functioning of markets through behind-the-border measures to reduce regulations, streamline policies, and promote enforcement. This framing of the concept has the advantage of appealing to a wider number of member economies, who then may be interested in contributing funds to underwrite activities.

This aspect of work on the Middle Income Trap is vital. However, this work on improving the environment for business also needs to be complemented by efforts to build capacity to produce and export more and better products. This could be an area for APEC's ECOTECH work. Interestingly, while APEC currently has working groups on technical cooperation for agriculture as well as the services trade – where member economies share information on best practice – there is no such equivalent for manufacturing.³⁵

In addition, there are dialogue groups for the automotive and chemical subsectors. Coming under the Committee on Trade and Investment, these provide a forum for technical and policy interchange and discussion – rather than capacity-building. However, there is no such body for the electrical or electronics sector, which is a vital and strategic sector for virtually all of APEC's middle income members.

CONCLUSION

The Middle Income Trap is a key area of concern for many of APEC's member economies. In order to focus attention, guard against complacency, and remain relevant to this interest group, the organization should incorporate the topic into future work plans. Furthermore, widening income disparities among its members could undercut momentum for reform.

While APEC does not have a large budget, deep research capabilities, or even means of pushing countries to pursue potentially painful measures, it can still play a role. Its experience in pursuing piecemeal and graduation reforms to facilitate trade and investment maps well onto many of the measures needed to improve the environment for doing business and facilitate greater innovation. In addition, the grouping's diverse membership and pervasive production linkages are assets.

That said, the current focus on structural reform to improve efficiency and the ease of doing business should also be bolstered by measures to encourage the acquisition of capabilities of firms in member economies to deepen technological capabilities and break into new export markets – particularly in strategic areas such as the electronics industry.

³⁵ The closest Working Group is the Policy Partnership on Science, Technology and Innovation – formerly called the Industrial Science and Technology Working Group. Current foci include climate change, traffic management, theoretical physics, as well as boosting R&D and supporting innovation. Most of these do not map directly onto the acquisition of production capabilities at the firm level.

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