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Middle-income claptrap

Do countries get “trapped” between poverty and prosperity?

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ECONOMIC backwardness has its advantages. Latecomers to industrialisation can follow the path their forerunners broke before them and perhaps skip some steps along the way. As a result, poor countries can narrow the gap with rich ones. But this happy principle of economic convergence does not always hold sway. Some poor countries fail to get going. Others make quick progress, then lose their way. The first lot are sometimes described as victims of a “poverty trap”. The second are increasingly described as casualties of a “middle-income trap”.

This trap, named by Indermit Gill, of the World Bank, and Homi Kharas, now of the Brookings Institution, worries policymakers from Malaysia to Mexico. It haunts countries that have escaped poverty but still await prosperity, threatening to turn their aspirations into disappointments and their economic miracles into a mirage. Whether China, an epic example of convergence, will succumb to the trap is “the question on everyone’s mind”, say Barry Eichengreen of the University of California, Berkeley, Donghyun Park of the Asian Development Bank and Kwanho Shin of Korea University in a paper published last month*.

But is the middle-income trap worthy of the name? Is there something especially treacherous about the levels of development that China is now approaching? Despite the term’s popularity, the theory and evidence behind it are surprisingly thin.

First, the theory. Rich countries boast the best technologies; poor countries the lowest wages. Middle-income countries have neither. Intuition suggests they must struggle to compete with countries above and below them. Poor countries also benefit from moving workers out of overmanned farms and into factories, where they are many times more productive. But a decade or two of fast growth will empty the fields of surplus workers, obliging countries to raise productivity within their factories if they are to make further progress. Their economies would seem to face a tricky jump from one growth model to another.

But intuition can mislead. Both pay and productivity exist along a continuum. Countries can remain “competitive” at any level of wages and productivity, provided one stays in line with the other. The evolution from one growth model to another is also continuous. Factories do not wait until the last
underemployed labourer has left the farm to begin improving the productivity of the workers who have already arrived. Moreover, as the urban workforce grows in size, a steady flow of new arrivals from the villages makes a smaller proportionate impact. China is a good example. Many worry that it has now exhausted its surplus labour and will slow sharply. But according to Louis Kuijs of the Royal Bank of Scotland, the movement of workers between agriculture, industry and services contributed only 1.4 percentage points of China’s annual growth from 1995 to 2012.

So much for the theory, what about the evidence? The middle-income trap is rarely defined clearly enough to be tested. Some of its proponents argue that middle-income countries typically grow more slowly than richer and poorer economies. That is claptrap. If anything, they grow faster. The left-hand chart uses the Penn World Tables, which compare incomes across countries and over time from 1950 to 2010. Economies with an income per head of $13,000-14,000 (at purchasing-power parity) achieved per-person growth of almost 2.9% over the next ten years on average. That is faster than the average for any other income level.

The MIT no one wants to get into

These excellent averages mask many failures, of course. Such disappointments are the subject of a pair of papers by Mr Eichengreen and his co-authors. They look at fast-developing countries (which enjoyed growth in incomes per head of at least 3.5% for seven years) that subsequently suffered a sharp slowdown (their growth over the next seven years slowed by at least two percentage points). In their latest paper, they argue that such slowdowns seem to bunch at income levels around $15,000-16,000 and $10,000-11,000 (measured at purchasing-power parity), not far from China’s present level.

Both papers are rich and rigorous studies of growth hiccups. But they do not provide compelling evidence of a middle-income trap. Their definition of a slowdown is compatible with simple convergence: growth that slows from 9% to 7% may qualify as a slowdown, but it in no way constitutes a trap. By their definition, even Singapore, one of the brightest examples of catch-up growth on record, has suffered several sharp slowdowns.

The authors explore why middle-income countries decelerate when they do. But they shed little light on whether they are more likely to do so than other economies. Their latest paper ignores any country with an income per head of less than $10,000. Since rich countries rarely sustain growth of over 3.5% and poor countries are excluded by design, it is hardly surprising that the slowdowns they unearth cluster in the middle-income ranges. If their method is applied to countries rich and poor, what does it reveal? In the right-hand chart we have done our best to replicate their method.
Per-person incomes of $10,000-11,000 and $15,000-16,000 no longer stand out as especially dangerous.

Development is a long and arduous process, during which economies continuously evolve in scope as well as size. Potential traps lurk at every level of income. There is no reason to single out the middle levels. In a recent paper Mr Kharas and a co-author likened the middle-income trap to the bunkers that lie in wait for golfers. Not every player falls into them, but every golfer should worry about them. It is an analogy that China’s golf-obsessed rulers would no doubt appreciate. But bunkers are not confined to the middle six holes.

Sources


"Globalization's Missing Middle", by Geoffrey Garrett, Foreign Affairs, 5 November 2004


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