

# Escaping the middle income trap



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12/2015

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Few countries escape the middle income trap. After 100 years of wars, occupations, and rebirth, Poland's economy bears the same relationship to Germany's as it did in 1918. Today's American south bears the same relationship to the north as it did in the 1840s. Economic structures change very slowly. But the middle income trap is not an economic trap. It is a political trap. Economic tools exist for overcoming it, but few countries use them.

### ESCAPING THE MIDDLE INCOME TRAP

| Salvatore Babones

2 ●

It takes a brave government to pursue national economic development against the opposition of entrenched special interests. Economically, both supply side and demand side tools are available. On the supply side, middle-income countries should invest heavily in site-specific human and physical infrastructure. It is not enough to entice a few top-level foreign investors. Public investments must be made to raise the productivity of millions of ordinary people.

#### Infrastructure – physical and human

This is easy to see when it comes to physical infrastructure. Econometric analysis has shown again and again that roads and airports boost output. Not only that, they boost incomes. And they are site-specific. A research center or logistics hub can be moved to another country. A road stays.

Roads and airports (and rail lines and water systems and ports and power stations and cold storage facilities and fiber-optic networks) raise the productivity of everyone who uses them or relies on them. Directly or indirectly, the whole economy becomes more productive. Even the worst driver drives better on a paved road than on an unpaved road.

The supply of human infrastructure is equally important. A lack of skills is one of the main barriers to economic development. Health and welfare systems are also important, but education is the key. But what kind of education? Every middle income country is over-supplied with top university graduates who often have to emigrate to find jobs. Further investments in elite education will only produce more emigration. There aren't enough office jobs to go around.

Middle income countries should focus instead on high schools, trade schools, and on-the-job training. The biggest productivity gains come from bringing up the bottom, not from raising the top. And it's much easier to do.

#### Weak currency - strong demand

Getting the supply side right is an important first step but it is not the end of the story. On the demand side, favorable exchange rates and good social policies are important for ensuring domestic demand for domestic goods.

A weak currency is indispensable for escaping the middle income trap. Japan's currency was notoriously weak throughout its

### ESCAPING THE MIDDLE INCOME TRAP

| Salvatore Babones

3 ●

entire period of rapid growth. Then Japan allowed its currency to double in value in the two years after the 1985 Plaza Accord. The result was a massive capital outflow, an asset bubble, and two decades of lost growth.

China devalued its official exchange rate by some 75 percent between 1979 and 1994. Like Japan before it, China accumulated massive foreign currency reserves as exports poured out. Since 1994 China has allowed its currency to slowly appreciate. Today China's currency is close to its true market price, capital is flowing out, and growth is grinding to a halt.

A weak currency does more than just stimulate exports. It changes the structure of demand across the entire economy. Generally speaking, rich people like to consume imported goods while poor people like to consume domestically-produced goods. With a weak currency, the rich man's Porsche becomes the poor man's potatoes.

This increases orders for domestic companies, stimulates domestic employment, and generates tax receipts as money is circulated inside the economy instead of leaking out. In economics this is known as the multiplier effect. The purchases of the poor generate

much more economic activity inside the country than do the savings of the rich.

### Economy of tomorrow

Social policies like minimum wages, collective bargaining, and social insurance that increase the spending power of low earners have similar effects.

When combined with supply-side policies that promote rising productivity, demand-side policies can raise ordinary people's incomes without generating unemployment. It is a widely-held myth that wages must be kept low to ensure full employment. The empirical reality is that high wages cut into profits, not employment. Healthy firms respond to high wages by increasing efficiency. Unhealthy firms go bust.

The state can and should play a major role in boosting economic growth. Private firms and individuals will only invest enough to compete in today's economy. Only the state can invest enough to shape tomorrow's economy. Today's taxpayers, companies, and elites won't like making sacrifices to build a better tomorrow. But a courageous government can raise an entire economy out of the middle income trap.

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