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# The Middle-income Trap in Asia

Asian countries, having reached the middle-income level by means of an export orientation supported by low-cost labor, are seeking new paths to growth. These countries face the “middle-income trap,” a stalling of economic growth before they succeed in becoming advanced countries. How can Asia’s middle-income countries avoid or overcome this trap? This edition of NIRA Policy Review argues that autonomous innovation is essential to the realization of sustainable growth by Asian countries, that efforts towards research and development, the fostering of human resources, and the provision of infrastructure will be necessary in order to promote innovation on the part of each of the countries of the region, and that Japan can contribute to this process in a variety of ways.

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# What is the Key to Long-lasting Growth in Asia?

**Motoshige Itoh** President, National Institute for Research Advancement (NIRA)

## Will Asian Growth Continue?

The 21<sup>st</sup> century will be the Asian century: This is a prediction which we have heard for many years now. Asian countries have achieved rapid growth in the past 30 years, which has seen the region becoming an increasing focus of attention from major powers such as the U.S. and Europe.

Today, however, many people are experiencing a certain doubt over whether Asia can continue to grow at the pace it has previously enjoyed.

For example, we might consider China, which has displayed vigorous growth for the past 30 years. China has outstripped Japan to become the world's second-largest economy, but having reached this landmark, its growth has begun to slow. While optimistic voices proclaim the slowing of the country's growth nothing more than an effect of cyclical factors, and confidently expect the growth rate to pick up again, other experts point to the structural problems which China is facing.

These include: A coming decline in the working age population, in part due to the effects of the one child policy which has been in effect for more than 30 years; increases in production costs due to increased wages and salaries; the prospect that it will be difficult for the country to continue to grow due to its excessive export-reliance; and the fear that worsening inequality and the contradictions inherent in one-party rule by the Communist Party will lead to social instability. Looking towards the future, I am certainly not alone in believing that the present slowing in China's growth rate is more than cyclical.

We might also consider the countries of Southeast Asia. The potential for industrial development in Vietnam and Myanmar is attracting attention. However, this development is still in its initial stages. Thailand and Malaysia, which displayed rapid growth prior to the Asian currency crisis, are no longer as much in the spotlight as they once were. The deceleration of their growth cannot be ignored.

Will Asia's growth continue? It is difficult to give a conclusive answer to this question. Views on the subject run the gamut from optimistic to pessimistic, and it is not possible to say which is correct. Above all else, what we need to recognize is that there is no single entity that we can comprehend with the term "Asia." There are diverse differences between the countries

of the region; there are also differences within countries themselves. In China, for example, it would be reasonable to say that the developed region close to Shanghai and the poor regions in the interior of the country are entirely different economies.

But nevertheless, it is necessary to have a "magic word" in order to commence a discussion, and in this issue we have sought it in "middle-income trap."

The concept of the middle-income trap has become widely known through its use in a report published by the Asian Development Bank<sup>1</sup>. Asia has demonstrated ongoing high growth, but the number of countries which have reached the advanced country stage is extremely limited. The majority of Asian countries have remained at the middle-income level.

The concept of the "poverty trap" has long been used in the world of economic development theory. This concept states that poor countries display structural problems which may be considered a "trap" preventing them from escaping poverty. The concept of the "middle-income trap" is derived from this concept, and states that middle-income countries tend to have structural problems which make it very difficult for them to become advanced countries.

The report by the Asian Development Bank mentioned above emphasizes that the Asian economy will look very different in 2050 depending on whether or not Asian countries fall into or escape from the middle-income trap. Policies to enable the trap to be evaded (technological development, the fostering of human resources, the provision of infrastructure, etc.) will be essential.

## What will Generate Continuing Growth?

Almost 20 years ago, Paul Krugman, then a professor at MIT, published an essay in the journal *Foreign Affairs* arguing on the basis of growth equations that Asia's growth could not continue indefinitely<sup>2</sup>. This essay made the sustainability of Asia's economic growth a major subject of debate.

Making use of results produced by Alwyn Young (then a professor at Boston University), Krugman's questioning of the sustainability of Asian growth presented an important set of considerations, and one to which the issue of the middle-income trap is intimately related.

The essence of the argument is that growth based on capital accumulation and the expansion of the working population will reach a limit at some stage. Beyond this limit, the technological innovation that economists term total factor productivity (TFP), or increases in productivity, become important.

A country is able to make the transition from low-income to middle-income status by means of factors such as investment and the transfer of technologies from outside. In addition, it is able to increase its population of industrial workers via large-scale migration of the agricultural population into the cities. The former farm laborers who support China's production for export are a textbook example. However, inputs of labor and capital cannot increase indefinitely. It is not easy to increase incomes to the advanced country level when growth is maintained exclusively by increasing inputs.

What is essential is to stimulate continuous innovation. This increases TFP. It is necessary to boost production through a continuing expansion of internal demand rather than an excessive reliance on exports. Increased incomes increase demand, and this increased demand stimulates production. This cycle is essential to the realization of sustainable growth.

With the advent of the Asian financial crisis, it appeared that Krugman's argument had been proved conclusive. However, today, when most of the countries of Asia have attained middle-income status, the issues are once again being discussed. Can the countries of Asia continue their growth and make the transition from their middle-income status to become advanced countries?

## Seeking Paths to Growth together, based on Asia's Diversity

For this issue of the NIRA Policy Review, we interviewed a number of experts holding differing perspectives regarding the issues discussed above. We have summarized their opinions in the Expert Opinion section of this issue.

There is no question that Asia is diverse. Although we may speak in general terms of the problem of achieving continuing growth, the issues are different in China and in Thailand. The perspectives adopted also produce their own differences. There are, for example, considerable differences in temperature between arguments from outside and arguments produced inside the country in question. There are even differences in the points which are most strongly emphasized by theorists and individuals involved in practical affairs. Rather than attempting to determine which is correct, it is necessary to think about growth in Asia with consideration of all of these multiple perspectives.

In this way we see that while there may be differences in perspective between experts, they share common views on a number of important points.

One of these is the importance of innovation. The generation of continuous innovation is essential to making the transition from being a middle-income country at the catch-up stage to becoming an advanced country situated at the leading edge.

Innovation is intimately related to the quality of human resources. In order to sustain continuing economic growth, a country must be able to secure excellent human resources. How to foster these human resources is a significant issue for middle-income countries. It goes without saying that the educational system is an important factor.

The active acceptance of direct investment from overseas and the provision of opportunities for local personnel to gain diverse experience at sites of production and development are also essential for the fostering of human resources. Different outcomes will be generated depending on the type of investment which is accepted. It is important to increase investment which offers opportunities for development rather than accepting investment which simply uses labor. Asian countries themselves understand the importance of fostering human resources, and are studying the introduction of systems and policy measures to stimulate progress in this area.

How can Japan contribute to the realization of continuing growth in Asia's middle-income countries, and how will it benefit from growth in the rest of the region? One area of considerable potential for Japan is the provision of direct investment which stimulates technological innovation. If other Asian countries are able to increase their capacity for technological development, Japan will be in a position to optimally distribute its knowledge and technologies between the countries of the region. However, in order to do so it would be essential to ensure that each of the countries concerned will respect intellectual property rights. As certain of the experts interviewed for this issue also indicate, the coordination of policy in soft areas, including intellectual property rights, between Asian countries by the Japanese government would create opportunities for growth both for Japan and the other countries involved. Some of the experts interviewed also point to potential contributions in the area of provision of infrastructure, which would act as a foundation for growth. This is a very interesting suggestion, especially given that infrastructure-related fields could become strong export industries for Japan. It will be necessary for us to expand on these arguments and suggestions to enable the realization of continuing growth for Japan and all the other countries of Asia.

\*1: Asian Development Bank (2011), "Asia 2050: Realizing the Asian Century," Manila.

\*2: Krugman, Paul (1994), "The Myth of Asia's Miracle," *Foreign Affairs*, 73(6).

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## Expert Opinions

# Are they facing the Middle-income Trap?

While the countries of Asia have continued to display buoyant economic growth, recent discussions have tended to focus on the “middle-income trap” – the inability to reach advanced country status without structural reforms. How should we consider this “trap”? What should Asia’s middle-income countries do in order to overcome or avoid this “trap,” and how can the Japanese government and Japanese companies assist them in doing so? In this issue, we take opinions from experts at the forefront of international institutions, academia, and the business world.

Interviewer: Akio Egawa, NIRA Senior Researcher  
Period of interviews: August - September 2012

## Paths to overcoming the trap are diverse

Haruhiko Kuroda

President, Asian Development Bank

The term “middle-income trap” originally refers to resource-producing countries such as certain Latin American countries which comparatively steadily achieved middle-income status, but have been unable to become advanced countries. However, the concept is not restricted to resource-producing countries. It is also applied to the argument of the possibility that the People’s Republic of China (PRC) and the nations of Southeast Asia, which have invested human resources including low-wage labor force into manufacturing to become a middle-income country, will fall into the middle-income trap.

Since the Second World War, the only Asian countries to have succeeded in becoming advanced countries are the Republic of Korea, Taipei, China, Hong Kong, China, and Singapore, the “Four Asian Tigers.” This fact speaks clearly of how difficult it is, compared to developing from a low-income to a middle-income country, to develop from a middle-income to an advanced country.

However, there is no need to pessimistically assume that the PRC and other Asian countries will fall as easily into the middle-income trap as the resource-producing countries mentioned above did. The PRC is also fostering entrepreneurs, and is focusing its energies on the provision of university education in science and technology, which will form the foundation for innovation. Up to the present, the PRC has employed borrowed technologies, and thus has not valued a price for intellectual property rights, but we may assume that it will enhance its treatment of intellectual property rights in order to protect innovation as it proceeds with its own technological development. Further afield, there is margin for the autonomous development of innovation in a diverse range of fields of industry – we see this in manufacturing industries in Thailand, service industries in India, the development of the world’s largest call centers in the Philippines, etc. Technological transfers through foreign direct investment are progressing, and locally-funded companies are also being fostered.

It is difficult to offer any single, uniform answer as to just what the “traps” are, and just what policies should be adopted in order to avoid those traps. The “Four Asian Tigers” themselves adopted a variety of industrial policies and laws and regulations. Efforts by the countries themselves will be fundamental in enabling Asian countries to become advanced countries, and to some extent the countries of Asia now possess the necessary

resources and strategies to make this happen. If Japan seeks to support such efforts, it will be important that this support is not imposed, but rather based on requests from countries with differing needs. ■

## “Beefing up” Asia’s economies

Eizo Kobayashi

Chairman, Itochu Corporation

Asian countries have realized economic growth in tandem with the Japanese companies that conduct business in them. Anxiety over the possibility of falling into the middle-income trap originates from a failure to accumulate technologies and expertise during the process of development, a failure to “beef up,” as it were.

Great things are expected from Asia, and I believe that Asian countries will continue to maintain high growth into the future. This includes China, which is in the process of modifying its trajectory from export-driven growth to an expansion of internal demand. However, in order to respond to these expectations, the Asian economies will need to “beef up.” First, the provision of social infrastructure, which is essential to business activities, is necessary, including ports and airports, public water and sewage systems, and power supply systems. If the infrastructure needed for a country’s development is in place, that country can resolve the issues it faces in the process of development by itself.

There is an enormous demand for infrastructure in Asia. However, many countries in the region lack the expertise to put that infrastructure in place, and this is an area in which Japan’s support can make a significant contribution to regional growth. The provision and fostering of human resources able to understand the diversity of perspectives and value judgments is needed for the operation and management of infrastructure. Assistance in this area would increase Japan’s profile in the region, and would benefit all the countries of Asia.

Against the background of European companies pulling capital and human resources out of Asia, Japan is once again being recognized by other Asian countries as a good partner for national development. In order for us to incorporate Asian internal demand into the Japanese economy, our product creation processes must be aligned with the sensibilities and needs of the region. In realizing this, it will be important for us to collaborate with local partners, and to assimilate well. ■

## We can avoid the trap by forming an ASEAN Economic Community

Thanong Bidaya

Chairman of the Advisory Board, TMB Asset Management Co., Ltd.  
Former Minister of Finance and Minister of Commerce of Thailand

The risk of falling into the middle-income trap is already an immediate prospect for Thailand. Due to low productivity in the agricultural sector, which employs the majority of the country’s population, the average income is still low, and there are significant income disparities between the country’s regions. This has made consumption weak and, as a result, Thailand is forced to rely on exports and direct investment. If productivity in the manufacturing sector, the country’s export sector, is not increased, the middle-income trap is approaching. It is essential to eliminate bottlenecks of logistics infrastructure, develop human resources, put flood-prevention measures in place, assimilate the agricultural labor force into the industrial sector and improve the financial situation of small and medium-sized enterprises. These solutions are comparatively simple, but initiatives in these areas have been delayed by political instability and corruption.

However, the formation of an ASEAN Economic Community would represent a tremendous chance for Thailand, located as it is in the center of the Indochina Peninsula, to increase its competitiveness and avoid the trap through a reorganization of its production processes which would also involve the surrounding countries. In order to make this possible, it will be important for the government to make efforts to reduce corporate taxes, promote investment in medium-sized enterprises and advanced technologies, protect intellectual property rights, increase the efficiency of the customs system, and eliminate unnecessary rules and regulations that increase the cost of starting a business.

Japan and Thailand have long collaborated to realize development. Our countries can continue to collaborate into the future in investment with a focus on the development of the entire Indochina Peninsula and in the reorganization of the region’s production processes. If Japan indicates what it needs from the countries of Indochina in terms of its strategy, the countries of Indochina will respond to those expectations. ■

## Political reform is essential to escaping the trap

Junhua Wu

Counselor, The Japan Research Institute, Limited

China has already fallen into the middle-income trap, or at the least is situated at the mouth of the trap. The obverse of the export- and government investment-driven high growth that the country has achieved since its accession to the WTO is the worsening of a variety of problems able to pull China into the trap, including the end of the country’s demographic dividend, income disparities, and the intensification of conflict between officialdom and citizens. Around 2000, China was already moving in the direction of the trap, and since then the country has been unable to make the transition from growth driven by the investment of resources to sustainable growth resulting from increased productivity. The slowing down of the country’s

economy should also be taken as a sign that China has fallen into the trap.

If the middle-income trap leads to economic stagnation and social disorder, the level of social conflict and conflict between the privileged and the underprivileged will increase. The Chinese government is instituting measures in response, but what the country needs to do is to increase productivity by building a society that respects knowledge and creativity. It will be essential for China to revise the one-child policy, remove the monopolies and oligopolies on state-owned enterprises in order to establish a market economy, and realize a fairer and more equitable society in order to raise the educational level of its citizens. The main impediment to the resolution of these problems is the vested interest of the executive of the ruling party and the government, including the managers of state-owned enterprises, and the intelligentsia. Political reform is thus essential. Merely implementing superficial measures, without reforming the single-party system, will not enable China to escape from the trap. ■

## Innovation is the condition for Asian development

Yasuyuki Todo

Professor, Graduate School of Frontier Sciences, The University of Tokyo

The term “trap” here generally refers to a situation in which the country concerned is unable to extricate itself from a condition of stagnating growth. Given that the countries of Asia have continued their growth since becoming middle-income countries, the use of the expression “middle-income” trap is slightly incongruous. However, they are facing a “trap” in the sense of not generating innovation, and it is possible that this could restrict their economic growth.

Long-term economic growth is only stimulated by innovation. Innovation is generated by consistent domestic research and development efforts and the fostering of increased knowledge; the diffusion of knowledge among domestic companies and the public increases productivity. By contrast, if economic growth continues on the basis of an excessive reliance on direct investment from overseas, R&D in the country concerned does not progress, and innovation is not generated.

By increasing government expenditure on R&D and promoting direct investment with R&D conditions attached, China has enabled technologies to strike root, and innovation is resulting. It is likely that China will not fall into the “trap.” However, numerous countries which rely excessively on direct investment and are not increasing R&D, such as Thailand and Indonesia, are in need of policies for the active promotion of domestic R&D initiatives.

Asia’s importance as a knowledge hub will increase in future. It will be important to make efforts to enable Japanese companies to build R&D networks throughout Asia, beginning with the adjustment of policy towards the protection of intellectual property. ■

### **What's NIRA?**

The National Institute for Research Advancement (NIRA) is an independent, private-sector research institute which defines urgent policy issues and formulates bold and timely policy proposals, seeking to contribute to the revitalization and further development of Japanese society and the Japanese economy.

Utilizing a network of scholars, researchers, and specialists in a wide range of subjects, NIRA works for the public benefit from a fair and neutral perspective, attempting to reinvigorate policy debate and contribute to the process of policy formation in Japan. The institute focuses on domestic social and economic policy, international relations, and regional issues in Japan as its principal areas of research.

Established in 1974 as a government-authorized independent research institution, NIRA became an incorporated foundation in 2007, and since February 2011 has been recognized as a Public Interest Incorporated Foundation.

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