Avoiding the middle-income trap

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A FEW YEARS AGO, when China looked at Brazil with great interest, it was not only to estimate its potential as a supplier of food and basic supplies for expanding its infrastructure. Nor was it only to investigate possibilities for investing China's large surplus savings. The strategy of the experts of the Asian giant had another aim: to analyze how the Brazilian economy had evolved since it recorded so much growth between the 1950s and 1980s, when per capita income quadrupled, and to identify what characteristics had kept Brazil from sustaining a similar pace of expansion to become a rich country.



The risk of stagnation that China feared is known as the middle-income trap, which holds back a large number of economies. Of 101countries that the World Bank considered middle-income in 1960, only 13 had become high-income economies by 2008. Otaviano Canuto, World Bank senior advisor, has commented that "If we extend this analysis to 2012, we will not see significant changes." In general, initially underdeveloped countries all had high productivity gains as workers transferred from less productive activities, such as traditional agriculture, to more productive ones, such as industry. In the process, the countries imported standard technologies and were able to compete internationally, exporting labor-intensive products. But, explained Fernando Veloso, IBRE economist, "When underdeveloped countries approach average income, factors responsible for growth to that point begin to run out, and economic expansion becomes dependent on productivity gains in industries that require more training and technology development."

As the challenges change, countries cannot always adjust accordingly. "History reveals that many economies can achieve middle-income status quickly, but few manage to get out of it because the political and institutional changes necessary are complex," said Zheng Bingwen, director of the Institute of Latin American Studies at the Academy of Social Sciences of China (ILAS-CASS). Canuto added, "This process occurred in Latin America in 1950 to 1970; successful countries like Japan also passed through it; and it is the reason that China has been able to achieve high growth rates in recent decades."

Recently, the Brazilian Institute of Economics (IBRE) and ILAS-CASS have been studying the topic. The results have been consolidated into a book, "*The Middle Income Trap: Visions of Brazil and China*," published by Getulio Vargas Foundation Press.

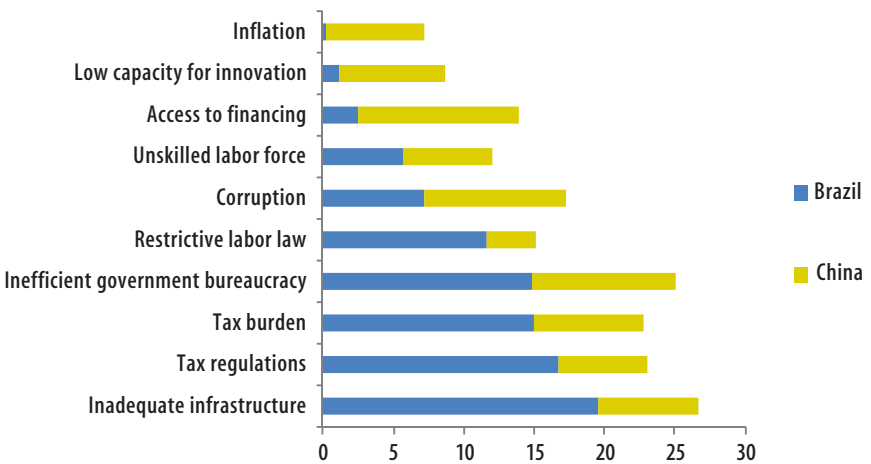
Veloso, one of the organizers of the program, believes that the middle-income trap is not inevitable. He assesses the drawbacks that caused the slowdown in Brazil's growth as due to an incomplete transition: "Our period of expansion occurred with strong state intervention in the economy, with an import substitution policy, a closed economy, and large subsidies to public and private companies. We changed policies

to allow more space for the private sector and a more open economy, but progress has been insufficient." Canuto pointed out that, similarly, in China the private sector will have to have more space to flourish independently. "This will require changes in the financial system, a different focus on property rights in private investment," he explained. "During this change, China runs the risk of making the same mistakes Brazil did. In principle, however, the Chinese have shown themselves to be more pragmatic than Brazilian leaders."

A successful transition to a high-income economy requires numerous changes, from educational development to improvements in the business environment, which will be analyzed in the following pages. Canuto noted that countries that have transitioned successfully to high-income status have a growing share of the population associated with innovation activities, a more skilled workforce, and sound infrastructure to support fluidity of ideas and synergies. He believes that an economy cannot move from middle- to high-income if it does not have a good business climate, low transaction costs, and a well-developed financial system to provide funding for innovative activities, adding, "When it comes to innovation, we speak of a process of learning that permeates the entire production system, including organizational adaptations, processes, products, and features of the local market."

International indicators of national business climate make clear the weaknesses of each country, showing where to focus reform efforts. The important thing, according to experts, is not to try to continue with policies that are ineffective for growth. Canuto explained that "Since 2008, countries like China, Brazil, India, and Indonesia were tempted to extend their older policies using the fiscal and monetary policy space rather than shifting to new policies. … In China, this was expressed in the fever of real estate investments through shadow banking." Canuto also sees a regression in Brazil's reform agenda.

Brazil and China: Factors clouding the business climate.



Source: *The Global Competitiveness Report 2013-2014*, World Economic Forum.