

Source: The Straits Times

Jun 24, 2011

Rising Asia and risk of middle-income trap

By Sanchita Basu Das, For The Straits Times



Rising Asia and risk of middle-income trap -- ST ILLUSTRATION: ERIC ROCA

MUCH has been said in the past few years about Asia's economic rise. The region's global credentials were buffed up even more when it demonstrated its resilience in the global financial crisis in 2008 to 2009.

And now, amid sluggish global performance and rising inflation, Asia's growth is set to remain robust this year. The pace has slowed down, compared to last year, but the region is still expected to grow by 8.4 per cent, with China (9.6 per cent) and India (8.2 per cent) leading the pack.

But many countries in Asia are either in or about to enter the 'middle-income trap'. This represents the stage where a country is stuck at a relatively comfortable level of per capita income (about \$7,500 to \$10,000) but cannot seem to take the next big step to become a developed nation.

Getting to the middle-income level is relatively simple. With low levels of income in the country, it can make the transition by taking advantage of the cheap labour available.

The real challenge comes when a country has to leap into the ranks of advanced economies. This is because, as incomes increase, so do costs, which means a country has to move up the value chain of production. In addition, the country will need to innovate and use capital and labour more productively. This calls for a better-educated workforce and higher investments in research and development.

Countries such as Malaysia, Thailand and the Philippines are now caught in the middle-income trap. Malaysia, after growing rapidly at 7 per cent from 1991 to 2000, grew by only 4.6 per cent in the 2001-2010 period. This fell far short of the 7.5 per cent growth rate targeted for the decade.

To tackle the problem, the government announced the New Economic Model in February last year. The plan aims to stimulate economic growth by improving worker productivity across all sectors of society. The government believes the model will help create a knowledge-based

economy, reposition Malaysia farther up the value chain, and propel the country to developed-nation status by 2020.

Similarly, Thailand could not make a timely transition from resource-driven growth, with low-cost labour and capital, to productivity-driven growth. The Philippines is also stuck. It can neither compete with low-income countries such as Cambodia and Laos, nor match up to innovative and knowledge-based economies like Singapore. Both Thailand and the Philippines lack policies that would enable firms to innovate and create active private-sector participation as well as build human capital.

Then there are Vietnam, China and India, which enjoy high growth rates but are on the brink of entering the middle-income trap.

Vietnam has managed to achieve rapid economic growth of 7.2 per cent in the past decade. It attained a per capita income of US\$1,173 (S\$1,448) last year, more than twice the US\$401 of 2000.

To avoid the middle-income trap, it needs the right kind of industrial policy, the proper development of financial markets to allocate risks and a well-diversified, employment-centric manufacturing sector. Policymakers have announced a vision of industrialising and modernising Vietnam by 2020. But the vision lacks concrete strategies.

Even China - the second-largest economy in the world - needs to brace itself for a slowdown in the coming years after maintaining strong growth for more than a decade. Admittedly, China has many advantages over other Asian countries. It has huge foreign exchange reserves, its exports are dominated by manufactured products and it can attract foreign investment because of its large domestic market.

But challenges still exist. The state sector dominates the economy and there is a lack of small and mid-size firms, which are crucial to the development of technical skills. Manufacturing costs are also likely to rise as wages go up and the government imposes restrictions to curb pollution.

Similarly, India has grown to become the third-largest economy in Asia and has enjoyed an 8 per cent-plus growth rate in the past few years. To join the ranks of advanced countries, India must tackle roadblocks such as rising inequality, lack of skilled labour, chaotic urbanisation, pressure on scarce resources, and broader issues such as social stability and climate change.

Most of these countries want to follow in the footsteps of South Korea. After nearly defaulting on its debts at the end of 1997, South Korea pulled itself together and has grown more than twice as fast as the OECD (Organisation for Economic Cooperation and Development) average. Its per capita income rose from 57 per cent in 1997 to 89 per cent of the group average in 2009.

The major changes that South Korea brought to its economy were liberalised imports, reduced powers of the chaebol conglomerates, investment in human capital and deregulation of the financial sector. The government's main focus was increasing economic competitiveness, which is

defined as strong institutions, efficient infrastructure, better health, education and training, efficient labour and financial markets, and more innovation.

The Asian Development Bank, in a recent study titled *Asia 2050: Realising The Asian Century*, stated that 'developing Asia is at a fork in the road; it could either climb onto the uplands of an 'Asian Century' or slide down the vale of the 'middle-income trap'.

According to the report, by 2050, the region could account for about half of global output, up from the current 27 per cent, as well as half of global trade and investment.

Whether an Asian Century comes about depends on how well the region addresses these issues: technical progress, capital accumulation, demographics and the labour force, the emerging middle class, climate change mitigation, competition for resources, and the communications revolution. If Asian countries fail to meet these challenges, over the next five to 10 years, they will fall into the middle-income trap of slowing growth rates and stagnating income levels.

The writer is lead researcher for economic affairs at the Asean Studies Centre, Institute of Southeast Asian Studies. These are her personal views.