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››› The current weakness of many emerging markets evokes the concept of the middle income trap

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Author: Dr Martin Raschen, phone +49 69 7431-2434, research@kfw.de

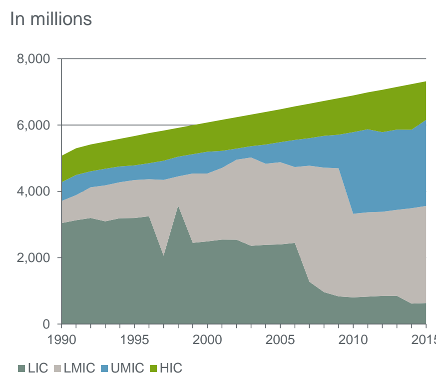
For a long time, countries such as the BRICS group were admired as up-and-coming emerging markets and advanced economies feared that BRICS and Co. would soon contest their position as leading economies. From 2006, however, researchers debated the theory that emerging markets would eventually hit a growth barrier and then become stuck in what was referred to as a middle income trap. The current crisis in Brazil, Russia, South Africa and others is giving this theory new timeliness.

Thanks to impressive convergence, three fourths of humanity today live in middle income countries

The World Bank divides countries into income categories. It distinguishes between low income (LICs), middle income (MICs) with the two sub-groups lower middle income (LMICs) and upper middle income (UMICs) countries, and high income countries (HICs). This subdivision is based on economic output per capita in US dollars, for which the World Bank updates income intervals annually in accordance with inflation. As the figure illustrates, in 1990 almost 60 % of humankind still lived in LICs (in 51 countries) and only 23 % in MICs (in 86 countries). By 2015, the share of people living in MICs increased to more than 75 % (in 108 countries today). The rise of the most populous country, China, from an LIC to an LMIC in 1997/1999 and later to a UMIC in 2010, and the transition of India from an LIC to an LMIC in 2007 made the greatest impact. Twenty-two countries took the leap from an MIC to an HIC since 1990 (including South Korea, the Seychelles, Oman and Uruguay).Three countries, however, fell back from MIC to LIC status (e.g. North Korea).

Figure: Distribution of world population by country income categories, 1990–2015

In millions



Source: World Bank, own calculation. China was classed as an LMIC in 1997 and again in 1999 after dropping to LIC in 1998.

The concept of the middle income trap

This "migratory movement" between country groups is impressive but does not allow any statement on the validity of the concept of the middle income trap. The concept was developed by World Bank experts in 2006 and claims that countries are trapped between poorer and richer countries after ascending to MIC status. Below the MICs are poorer countries with a large low-wage sector which they employ, as do the MICs, in an effort to penetrate industrial sectors with simple technologies (e.g. textiles and toys). Above the MICs are advanced economies with innovative high technology the MICs cannot compete against. Specifically, the problem, or the "trap", is that the previously successful ascent from an LIC to an MIC is based on a specific growth strategy that is now unsuitable to ensure the further transition to an HIC. The countries were able to overcome the LIC status by creating physical capital through high investment and combining it with workers from the less productive farming sector, or who were previously unemployed, to make simple manufactured goods. Little by little, however, workers become scarce, wages rise and their competitive advantage over LICs shrinks. A transition from an MIC to an HIC is possible, but requires another strong productivity surge that must be more than continued capital accumulation and redirection of labour.

Ways to prevent / overcome the middle income trap

As described, since there have been successful advances from MIC to HIC status, the crucial question is what economic-policy instruments an MIC should deploy to keep from falling into the "trap" or escape from it. The specialist debate, however, offers hardly any new keywords beyond the familiar ones. Good approaches to achieving the necessary further productivity boost of an MIC are good governance (efficient public administration, corruption prevention, etc.), good macroeconomic policy, an efficient financial sector, investments in education / human capital and health, open domestic and external markets, a needs-based infrastructure, a functioning labour market that includes measures aimed at achieving a "demographic dividend", etc.

Conclusion

Many ailing emerging markets have long benefited from favourable external factors (e.g. high commodity export prices) that masked significant deficits in the internal conditions mentioned above. The debate on the middle income trap can therefore provide these countries with useful indications on how they can overcome the current weakness and advance to a higher country category. ■

Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.