

## Middle Income Trap – ADB Seminar

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Hanoi, May 6, 2011

### 1. What is a middle income trap?

My definition of middle income trap is simple. When a country attains certain income because of given advantages, the country will get stuck there. If a country has a large population and limited natural resources, it will stay at low income. This is called a “poverty trap.” A country with a small population and lots of oil will automatically attain high income. That’s enrichment through good luck and no effort. And if a country has an average amount of advantages, it will be caught in middle income. So, a middle income trap is a special case of more general developmental traps. I do not consider this kind of income achievement as true development. We may envy lucky countries but we don’t need to respect them as model performers.

Given advantages include not only natural resources but also certain locational advantages which attract FDI, foreign aid and other capital inflows. When a large amount of foreign money comes into a country, it creates construction booms, consumption booms and asset bubbles. Big projects are undertaken in infrastructure, industry and tourism. But these can occur in any country without any rise in productivity. I don’t consider this as true development worthy of praise and emulation.

To attain given income, countries just need to liberalize, privatize and open up. This will take you there but not beyond. Free market alone is not enough to take a country to high income. You need more proactive policies to realize that.

The source of high income is human capital. This includes skills, technology, knowledge and innovation. In the early stage of development, the main focus should be productivity. In a later stage, focus should shift to innovation. In either case, continuous human capital accumulation can be realized only by a combination of good policy and private dynamism. The private sector should be the main engine but policy must guide and support it. Only those countries that establish a national mechanism to promote—and even force—human capital accumulation can escape from the trap and attain high income, not because of resource revenues but because they create values that the world wants. I think that’s true development—something that everyone should admire.

One important fact is that countries have different policy capabilities and different private dynamism to start with. When Japan learned textile technology from the UK in the late 19th century, it took only a few years to build a commercially viable cotton mill and only a few decades to beat the British textile industry in the global market. When Korea learned steel, automobile and electronics from Japan, more or less the same things happened. But when Malaysia learned automobiles from Mitsubishi or when Brazil learned integrated steel mill from Nippon Steel Corporation, they never really graduated. Even today, Japan is sending automobile experts to Malaysia and Brazil is receiving assistance from Nippon Steel. Korea's POSCO and Brazil's Usiminas are not the same. Why is this difference? It is not how Japan taught. There is something on the recipients' side that makes this difference. Not all countries are created equal. This may not be fair but that's how the world is.

## 2. Policy learning

Let me turn to industrial policy debate. As you know, neo-liberal economists argue that government should be small. On the other hand, people like Joseph Stiglitz, Justin Lin, Dani Rodrik and Ha-Joon Chang say free market is not suitable for industrialization. However, I am afraid this kind of debate is too general and academic. It is not very useful for governments that have already decided to play a key role in national development.

I travel extensively in Asia and Africa. I can tell you that the number of countries that want to move away from free markets and seriously try industrial policy is increasing. Action-oriented governments want to know where to start, and how to design and implement policies concretely. For such countries, my suggestion is policy learning – *systematic* policy learning.

Very few countries have achieved high income. But the important fact is that some countries did this, and we can learn from them. If you want to know more, I recommend you to visit Singapore, Taiwan and Korea and ask how their governments make policies. I think you will be truly amazed.

Policy learning is NOT about copying some policy adopted in some other country without local context. Ad hoc and random copying should be avoided. What needs to be learned is *mindset* and *methodology*. Governments must learn how to create a policy package most suitable for the home country.

My proposal is that we should systematize policy learning based on international comparison of best policy practices. I suggest that international and regional organizations, such as ADB, will take a serious look at this problem. Japan has done a lot of policy dialogue and policy-related technical assistance with developing countries. Korea has launched the Knowledge Sharing Program, which is a national program to disseminate Korean development experience through policy dialogue and study modules. Singapore has taught productivity movements to a number of countries, including some African ones. I hope ADB or someone else will become an information hub of such bilateral efforts and systematize East Asian knowledge.

### 3. Mindset change

Now there is another problem that leads to the frustration of industrialization effort. That is the problem of a weak private sector. As I said before, not all countries are the same. In Japan and Korea, the private sector responded strongly to policy initiatives. However, in most other countries private sector dynamism is not very strong. Firms and workers may continue to prefer short-term gains, job hopping and real estate speculation rather than long-term investment in manufacturing and technology.

I conduct regular policy dialogue with Ethiopia, a poor African country without resources. Prime Minister Meles of Ethiopia once asked me: "We have learned a lot about industrial policy and implemented many measures (Ethiopia learned from Korea, and more recently from Japan). But my people are still building too many urban apartments and not investing in factories. Can you tell us how East Asian governments transformed these speculators into manufacturers?"

In Malaysia, Dr. Mahathir wrote a controversial book, *The Malay Dilemma*, in 1970. His main argument was that Malay people were not as economically dynamic as Chinese immigrants and therefore needed some protection. As you know, Malaysia has implemented Bumiputra policy, the affirmative action plan for indigenous Malays, for four decades but we have not seen a surge of Malay entrepreneurs conquering the global market yet. Last year, Prime Minister Najib has launched a new policy drive, called New Economic Model, to promote value creation and innovation.

I feel that Malaysia's SME policy and FDI policy are pretty good. I also feel that Malaysian officials are more competent and more highly motivated than Japanese officials. But Malaysia is not rising to the same level as Singapore or Korea. Why? I don't think the solution lies in making policies even better and more sophisticated. The problem in Malaysia is not mainly with policy quality but with the mindset of the private

sector. And this requires another type of policies—policies to energize a sleepy private sector into action. This is a very difficult task.

But high income countries in East Asia have already mobilized such policies—policies which I call “national movement for mindset change.” It is a policy involving the entire population for a decade or more, to transform the popular mindset toward hard work, teamwork and creativity. In the 1950s, Japan launched a productivity movement featuring QC circle. In the 1970s, Korea launched Saemaul Movement which transformed Korean villages significantly. In the 1980s, Singapore engaged in Productivity Movement in which even taxi drivers talked about productivity. And after these movements, these countries became more productive and competitive. So national movements are possible. But success requires international learning, just as industrial policy must be improved through international learning.

#### 4. Summary

Let me summarize. Middle income traps must be overcome by installing a national mechanism to promote human capital accumulation. For this purpose, I propose systematic policy learning based on international comparison of best policy practices. Government must improve its own policies, and at the same time must energize the private sector if it is not responding strongly to improved policies. I believe this subject is very important and warrants a more serious study in the future.