

EMERGING ASIA ECONOMICS FOCUS

4th Jul. 2011



Can Asia avoid the middle-income trap?

- **Most of emerging Asia should continue to grow rapidly for at least another decade, and much longer if the right policy choices are made. The key exception is China where, despite a bright long-run outlook, structural reform is needed sooner rather than later to reduce the danger of a slump in the next few years.**
- Many middle-income countries struggle to sustain rapid growth. At the root of the problem is a failure to raise productivity once the easy gains that come when workers move out of agriculture have dried up.
- **This shift of workers still has at least a decade to run in emerging Asia's most populous economies.** Demographic trends are also favourable and, for India in particular, there are potentially huge gains to be had from encouraging more women into paid work.
- Even so, some countries are already focusing on the productivity improvements that will ultimately be needed to lift them to high income. For example, both India and China already spend a larger share of their income on research and development than Latin America.
- The drive to raise productivity is linked to the open, competitive nature of most Asian economies. **Geography helps too: since 1990, eight major economies have escaped middle income (a fact which, in itself, implies the "trap" is not *that* hard to avoid). All but two of these successes are in Asia or Europe**, where proximity to existing trade networks facilitates rapid productivity gains as poorer countries catch up.
- In other words, conditions are in place to support continued rapid growth in emerging Asia for at least another decade and possibly much longer. Whether this potential is fully realised depends on the success of efforts to tackle constraints to growth. In India, for example, these include the poor quality of education and infrastructure.
- The biggest near-term challenges are in China. The country's long-run outlook is still bright but China faces a difficult task right now in re-orienting its economy to be led by household spending. **Government efforts have so far failed, raising the threat that the continued reliance on investment will result in a sharp slowdown in China's growth at some point in the next five years.**

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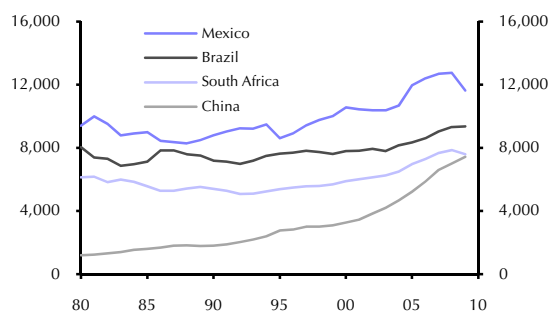
Can Asia avoid the middle-income trap?

This Focus is an adapted version of a presentation given at the Capital Economics Emerging Markets Forecast Forum held in London on 28th June.

We are all used to hearing claims that this will be the Asian century or that China will eclipse the US economy in the not too distant future, with India not far behind. But very few countries manage to sustain rapid growth over a period of decades. Many countries have a good run of ten or twenty years but then growth fades and they end up in what is sometimes called the “middle-income trap”.

For example, annual real income growth has averaged under 1% over the last three decades in places such as Mexico, Brazil, and South Africa. (See Chart 1.) Even in the UK and the US, annual growth has been twice as fast.

CHART 1: REAL PER CAPITA INCOME (\$, PPP)

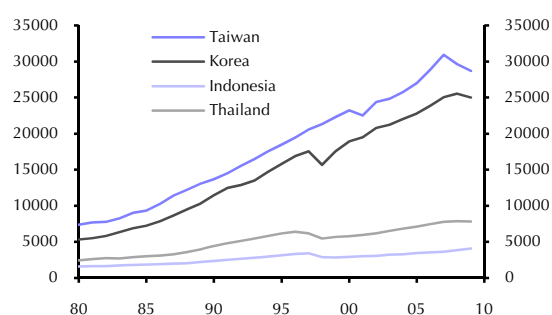


Source – Penn World Tables

Much of emerging Asia is now approaching that middle income level of between \$5,000 and \$10,000 per person where many countries seem to struggle. The increasingly-common belief is that the rest of the region will follow the path of Taiwan and Korea, which went from being poor to being rich in two generations. But only a handful of countries have ever done that. We can't exclude the possibility that emerging Asia will end up looking more like Brazil has over the past few decades, catching up with the developed economies very slowly or maybe not at all. There

are already suggestions that income growth is slowing in countries such as Thailand and Indonesia. (See Chart 2.)

CHART 2: REAL PER CAPITA INCOME (\$, PPP)



Source – Penn World Tables

In this *Focus*, we first ask why many middle-income countries struggle. The answer lies in what drives the growth of rich and poor countries. By looking at the individual growth drivers we can draw some conclusions on how long emerging Asia can maintain its rapid growth. This leads to a view on which countries are likely to outperform expectations over the long-run and which are likely to struggle.

Why might there be a middle-income trap?

For any given country there are of course specific problems. In Brazil for example, there was the debt crisis of the 1980s. But we can make some general observations about the challenges facing countries that are no longer poor but not rich either.

At low income levels, countries typically grow by bringing more workers off the fields and into factories and by investing. These countries don't have to worry too much about technology because at low income levels it is simple enough to copy basic technology from elsewhere.

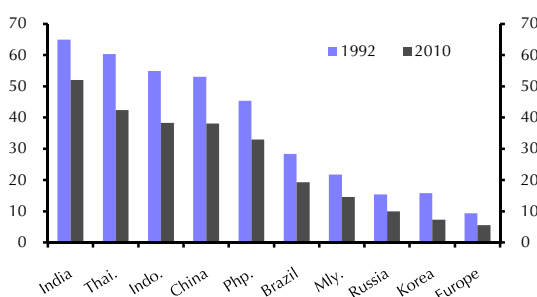
But once most workers have already moved and when the capital stock is already fairly large, countries have to rely more on improving the technology they use and raising overall

productivity. This requires an entirely new set of skills.

Workforce shift still ongoing

So the question really is how close Asia is to that turning point. We know that investment has grown rapidly in Asia and you can see from Chart 3 that in India, Indonesia and China, about one in seven workers have moved out of agriculture into manufacturing and services since 1992.

CHART 3: SHARE OF WORKERS IN AGRICULTURE (%)



Sources – World Bank, CIA

But you can also see from Chart 3 that this process still has a long way to go before the workforces of Asia start to look more like those of Europe, where only 6% of workers are still in agriculture, or even like Brazil did back in 1992. **Emerging Asia still has relatively straightforward means to boost labour productivity.**

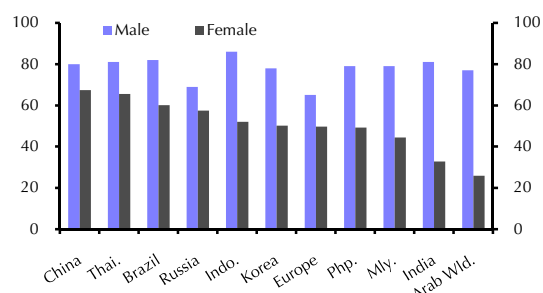
But there are exceptions. In Malaysia and Korea, the process has already run its course. These two countries have very low levels of agricultural employment with Korea now indistinguishable from a European economy in this way.

Another way to increase employment in industry is to encourage more women to work outside the home. In most emerging economies, around 70-80% of men are working at any one time but there is wide variation in how many women are in paid employment. (See Chart 4.)

In China, it is not far short of the share of working men. At the other end of the scale, only a quarter of working age women in the Arab world are

employed and not many more in India. **If India's female participation rate was more like China's, India's effective workforce would increase by about a third.**

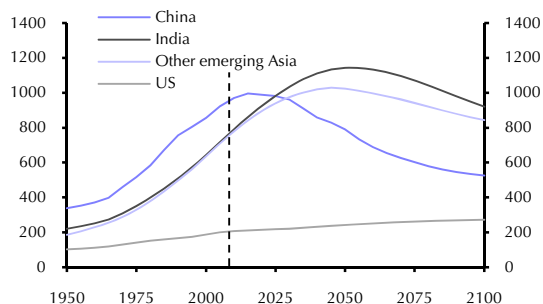
CHART 4: SHARE OF ADULT POPULATION IN PAID WORK (%)



Source – World Bank

Finally of course, population growth matters for total GDP. Emerging Asia's working age population has almost doubled in the last thirty years, adding significantly to overall productive capacity. The workforce in most of the region will continue to grow rapidly for another couple of decades, but it has nearly peaked in China – and on current projections will be only twice the size of the US workforce by the end of the century. (See Chart 5.)

CHART 5: WORKING AGE POPULATION (MILLION)



Source – UN

China's pool of "surplus workers" – the large number of underemployed workers that kept rural wages down even as migration soared – has also almost dried up. (See our *China Economics Focus*, "Is China running out of cheap workers?" 29th June 2010.) Remember though that nearly two out of

every five workers in China are still in agriculture, so big gains can still to be achieved moving workers to more productive parts of the economy.

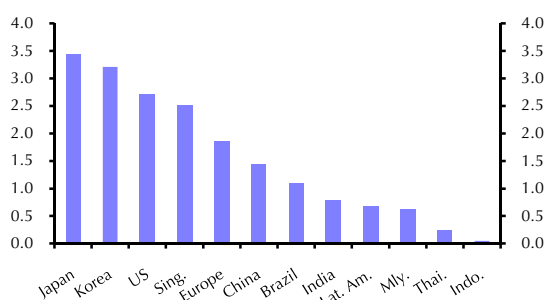
So the first point is that emerging Asia is still 10 or 15 years away from having to change its growth model. The second point is that China in particular is already laying the groundwork for that shift.

Seeking inspiration

One sign is how much is being spent on research and development (R&D): the success of Japan, Korea and Singapore was linked to their very high spending on R&D. Most of emerging Asia still lags behind most of Latin America. Indonesia for example barely spends anything on R&D at all.

But China already spends nearly as much on R&D as Europe. (See Chart 6.) And China's new Five-Year Plan includes a pledge to increase spending to 2.2% of GDP by 2015, which would put it not far short of where Singapore is today and among the world's biggest spenders on R&D.

CHART 6: R&D SPENDING (% GDP, LATEST AVAILABLE YEAR)



Source – World Bank

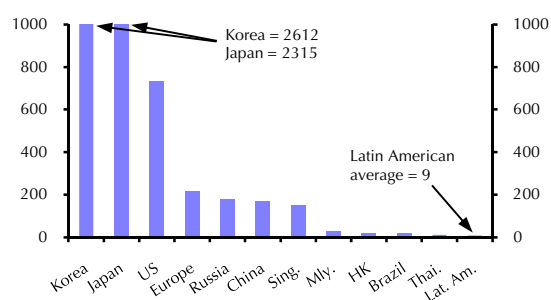
Another way to look at this is the number of patent applications per capita. Again, China has ambitious targets in its Five-Year Plan. But you can see that it has already overtaken countries in Latin America which are much richer and, in a sense, are in greater need of innovation. (See Chart 7.)

These measures don't capture everything. They don't tell you about the quality of the patents being filed or the effectiveness of R&D spending. But

studies show rapid technological improvement at the firm level too.

To understand why productivity is rising so fast in emerging Asia it helps to think about the environment the region's firms are working in. Most are in very open economies, where they face competition from foreign firms, and they also tend to sell a high proportion of their output abroad, where they compete with firms from around the world. As a result, Asian companies are under immense competitive pressure to raise efficiency.

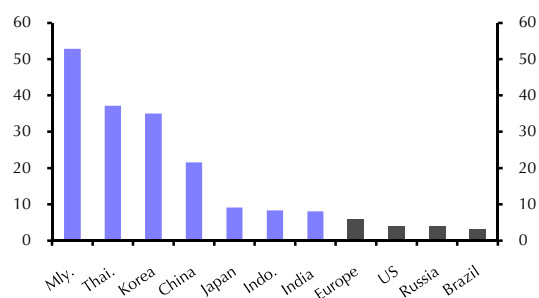
CHART 7: WORLDWIDE PATENT APPLICATIONS (PER MILLION PEOPLE)



Source – World Bank

Contrast that with the situation in Latin America: economies here are less open, and a large share of what they export is commodities, which provide fewer opportunities for productivity gains. Exports of manufactured goods are lower in Latin America than Asia (see Chart 8), and so the pressure on firms to keep improving efficiency and technological capacity simply isn't there.

CHART 8: MANUFACTURED GOODS EXPORTS (% OF GDP)



Source – UN Comtrade

The export sector matters in another way, which is that strong networks have developed within the export processing industry in East Asia which provide major benefits for any economy that happens to be nearby. Over the past half century we've seen the manufacturing export sector spread from Japan, to Taiwan and Korea, then southeast Asia and China, and now Vietnam.

These countries have benefitted simply by being in the right place, near to each other and to established shipping lanes. At this late stage, it is unlikely that a similar network will appear from scratch in Latin America or Africa, say, giving emerging Asia another long-run advantage.

Stumbling blocks ahead?

Overall then, it seems that conditions are in place to support continued rapid growth in Emerging Asia. It will be another decade before the shift of workers from agriculture into manufacturing and services slows, and some parts of the region are already focusing on the productivity improvements needed to lift them to high income status.

Meanwhile, geography is in Asia's favour. **Since 1990, eight major economies have risen to high income status** (as classified by the World Bank). **All but two of them are in either Europe or Asia**, areas where well-established trade networks provide a further boost to growth. (The exceptions are Saudi Arabia and Oman.)

Before we move on, it is worth focusing for a moment on that point: very few countries have moved from poverty to wealth in a short span of time. But several countries have managed the shorter journey from middle income. **The middle-income trap is not as hard to escape as is sometimes claimed.**

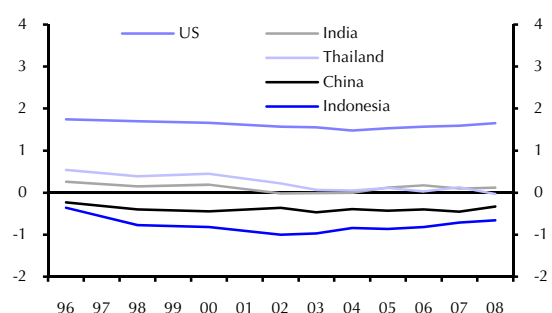
Nonetheless, the next decade or two won't all be plain sailing for emerging Asia. We have established that the region still has the potential to continue growing rapidly, but it will only do so if constraints on growth are removed.

The most important of these for the region as a whole is probably the quality of policymaking and institutions. Asian economic policymakers are widely regarded as having done a good job managing their economies over the past decade and they came through the global financial crisis relatively unscathed.

But the broader institutional framework has not kept up. Chart 9 shows a World Bank index measuring the "rule of law". It includes property rights protection, the enforceability of contracts, independence of the judiciary, and the effectiveness of the legal system in general. As these countries pursue structural reform, such things will be increasingly important to ensure that policies are implemented for the broader good and not to benefit vested interests.

The "rule of law" in emerging Asia seems to be worse than a decade ago, and the gap with developed economies, such as the US but also Japan and Korea, has widened.

CHART 9: RULE OF LAW INDEX (GLOBAL AVERAGE = 100)



Source – World Bank

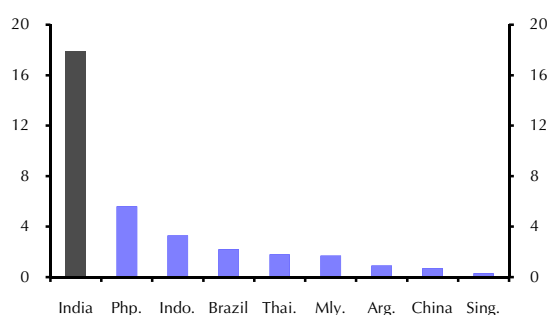
Talking in such broad terms can only take us so far. The path that various countries follow over the next decade will largely be determined by how effectively they tackle their specific challenges.

In India, for example, we saw earlier that it could increase its workforce significantly if it could increase the share of women in paid work. Demographic trends are also favourable, with the working age population set to rise by a third over the next two decades. But this will only translate

into rapid GDP growth in practice if there are sufficient employment opportunities.

That will require cutting red tape and also improving the quality of education. Levels of illiteracy today are far higher in India than in other parts of the emerging world. (See Chart 10.)

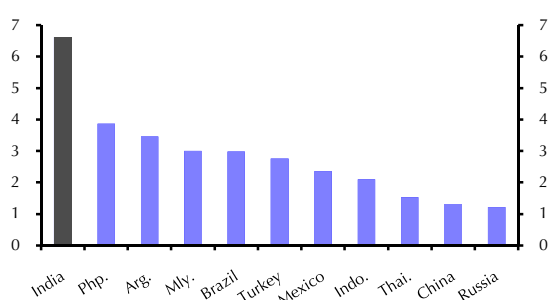
**CHART 10: YOUTH ILLITERACY RATE
(% OF POPULATION AGED 15-24)**



Source – World Bank

The second key constraint for India is the quality of its infrastructure. Indian firms claim that power cuts costs them nearly 7% of potential sales – nearly twice the level in any other country we look at. (See Chart 11.)

CHART 11: SALES LOST DUE TO POWER SHORTAGES (%)



Source – World Bank

Poor infrastructure and low literacy can be seen as positives for potential growth – if India can grow at 8% a year with these constraints, just think what it could do if they were removed. But this brings us back to the importance of having high quality institutions that are able to tackle the constraints to growth.

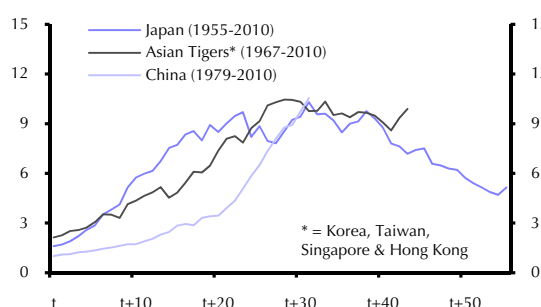
Bigger challenges for China

What about China? The rest of emerging Asia may have a decade before its growth model has to change, but there are two issues that will require China to act much sooner. These are its size and its economic imbalances.

China differs from other fast-growing Asian nations in that it has become one of the world's largest economies while still relatively poor. China's low income means it could potentially continue to grow rapidly for decades. Its size means this will increasingly create friction.

Take, for example, China's share of world markets. Chinese exports have followed a similar path to those from other fast-growing Asian economies over the first 30 years of rapid growth. (See Chart 12.) But there is no sign that China's share of export markets is levelling off, as happened with Japan and the Asian Tigers. As China's export share rises, there is a growing risk that it will trigger a protectionist backlash, particularly since China's strength as an exporter is not matched on the import side.

CHART 12: EXPORTS (% OF WORLD GDP)

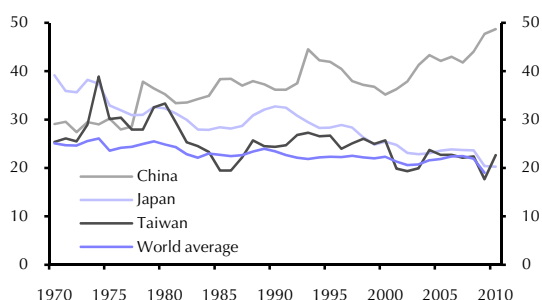


Source – Thomson Datastream

The second, related point is how weak domestic consumption is relative to total Chinese output. China's growth has been far more investment-intensive over the last thirty years than the Asian norm. It now invests close to half of its annual income, which is well ahead of the peak level of investment seen in any other Asian economy. (See Chart 13.) That has given China much stronger

infrastructure than the average emerging economy but this model looks increasingly unsustainable.

CHART 13: INVESTMENT (% OF GDP)



Sources – World Bank, CEIC, Thomson Datastream

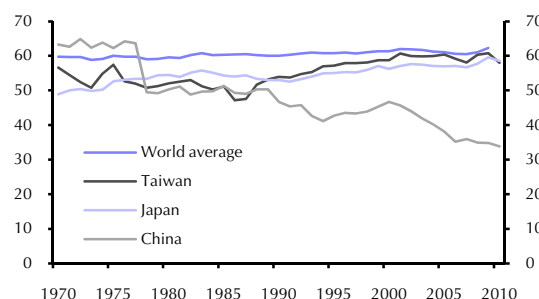
First, the continued reliance on investment to fuel growth raises the likelihood that China’s potential output will increase much faster than its actual demand. This will play out either in the return of large trade surpluses or in industrial overcapacity and a cyclical plunge in spending.

The second problem is that successful investment-led growth is increasingly reliant on having effective financial markets to channel investment. China’s banking system is still dominated by the state and likely to remain that way at least until the bad debt problems of the recent stimulus have been resolved. In the meantime, the danger is that much of China’s investment is wasted.

Of course the ideal way out would be for household spending growth to pick up, allowing a gentle slowdown in investment relative to GDP. That has been a central government goal for several years but there has been no progress so far. (See Chart 14.) Households’ share of total spending has dropped to little more than half the global average. One of the reasons is that changing the growth model involves steering resources away from well-connected state-owned firms towards households, but vested interests stand in the way.

So while we are positive about China’s long-run outlook, the next few years will throw up challenges. **A slide in China’s growth to, say, 7% at some point in the next five years is plausible.**

CHART 14: HOUSEHOLD CONSUMPTION (% OF GDP)

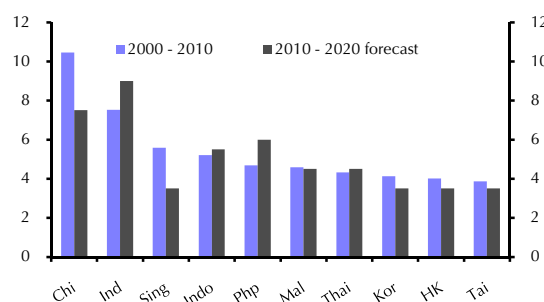


Sources – World Bank, CEIC, Thomson Datastream

The 10-year outlook

After a potentially bumpy ride in the next few years, we think growth in China will average about 7% over the next decade. That is still strong, but well below most expectations – the latest consensus forecasts are for steady 9% growth for several years to come. The other big slowdown we are forecasting is in Singapore – but this is more a sign of success than failure: average incomes there are already level with those in the US and we are still forecasting trend growth of 3 or 4% over the next 10 years. (See Chart 15.) **And there are a number of countries where prospects are improving. Foremost among these is India, which is soon likely to be growing faster than China.**

CHART 15: ANNUAL AVERAGE GDP GROWTH (%)



Sources – IMF, Thomson Datastream, Capital Economics

Overall, the message is positive. The consensus is probably underestimating the risks of a medium-term slowdown in China. But, in general for the region, we believe the stage is set for another decade or more of rapid growth.