

**The Rise of China and Breaking out the Middle-
Income Trap in Latin America and the
Caribbean countries:
A New Structural Economics Approach**

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Outline

- **The Middle-Income Trap in LAC countries**
- **The opportunities and challenges of the rise of China**
- **New Structural Economics and Growth Identification and Facilitation: Implication for Latin America**
- **Concluding remarks**

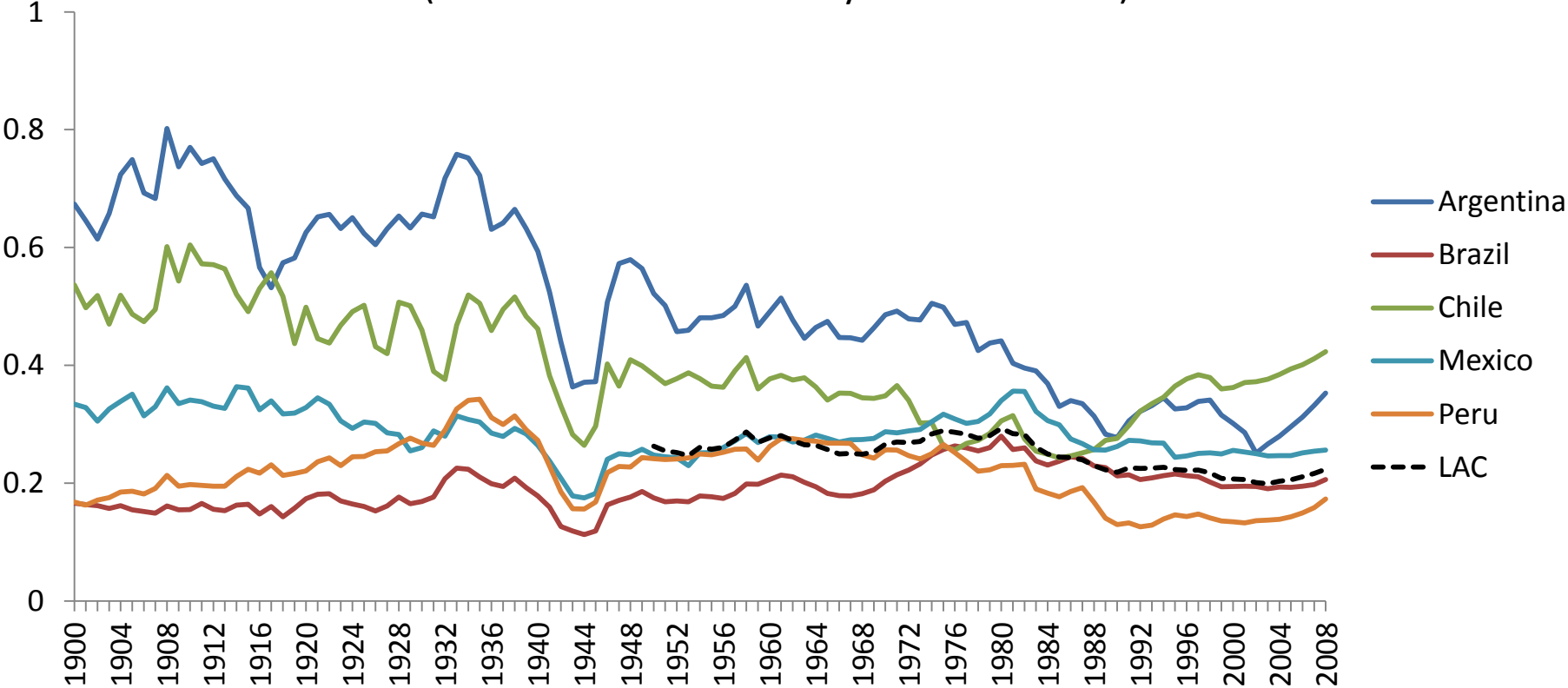
THE MIDDLE-INCOME TRAP IN LAC COUNTRIES

The economic performance in LAC in the new century

- Since 2000, the growth performance in Latin America and Caribbean (LAC) countries has been improved.
- The LAC economies have been resilient during the recent crisis. In fact, the region's recession was relatively short-lived (except for Mexico)
- For the first time poverty and income inequality have also been reduced
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But LAC remained trapped in the middle-income status

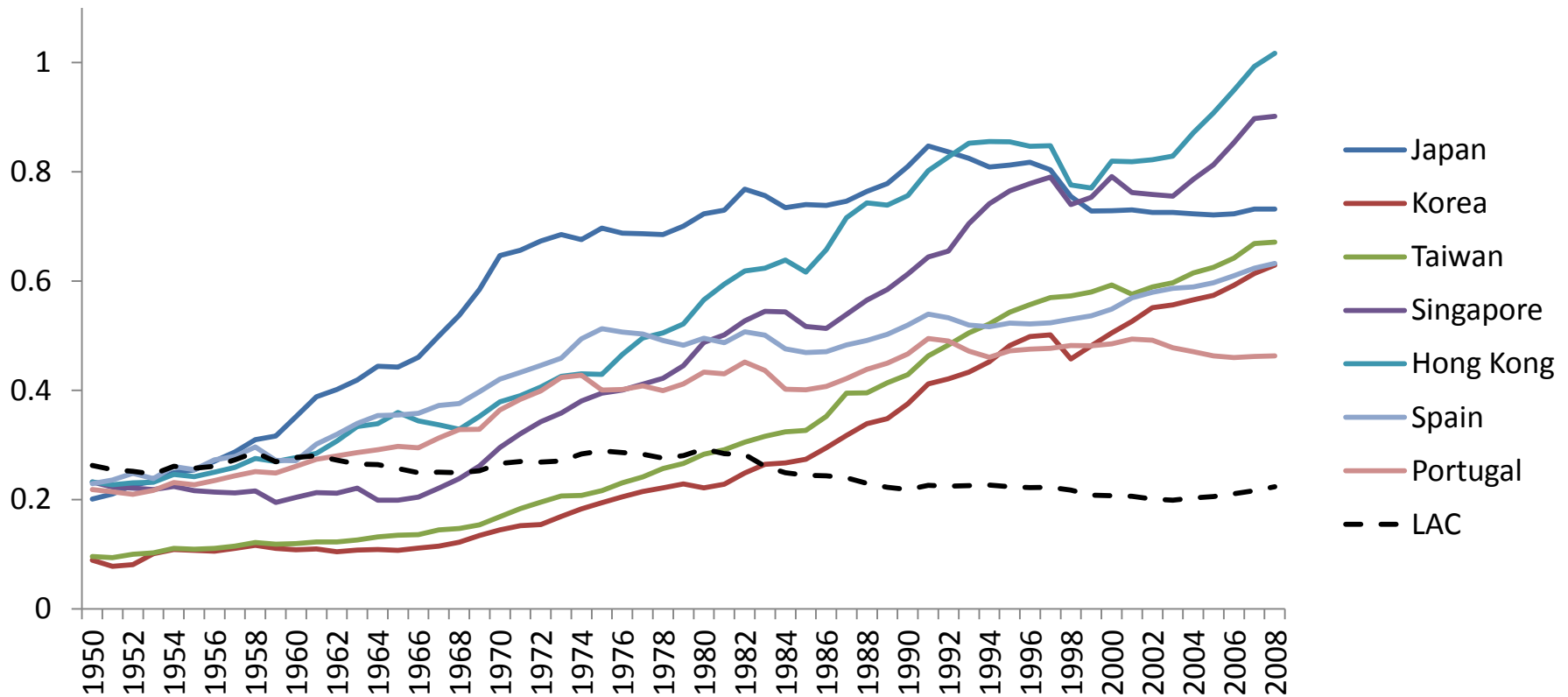
Ratio of Selected LAC Countries' GDP per capita to US GDP per capita
(1990 International Geary-Khamis dollars)



Source: Maddison (2010).

Middle Income Trap is not a destiny

Figure 2: Ratio of Newly Industrialized Countries' GDP per capita to US GDP per capita
(1990 International Geary-Khamis dollars)



Source: Maddison (2010).

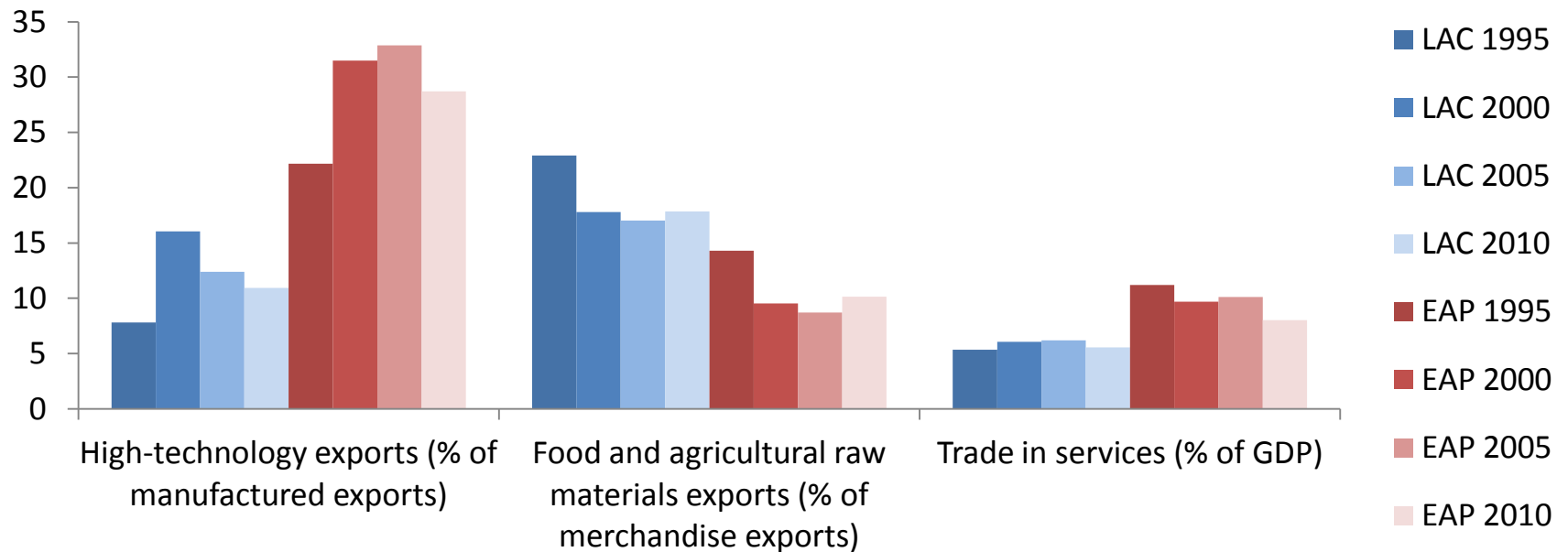
Cause of LAC's Middle-Income Trap

- Continuous technological innovation, industrial upgrading, economic diversification, and an acceleration of income growth are the main features of modern economic growth.
 - Growth theory has diverse approaches, but largely agrees that **variations in living standards mostly reflect differences in capital accumulation and productivity growth.**
 - **Productivity growth is associated with technological innovation and structural change**, i.e. productivity growth is linked with reducing the costs of producing the same outputs using better knowledge and relocating resources from lower value-added industries to higher value-added industries.
 - **Only with the technological innovation and structural change will return to capital not decline and there will be incentives to maintain high capital accumulation.**
- **Latin America countries' middle-income trap is a result of their inability to continue the process of industrial diversification and upgrading.**

Key challenge: Lack of Structural Transformation

- East Asia has been engaged in rapid structural transformation towards higher value-added products, while LAC's competitiveness in these sectors has declined.

Figure 4: LAC and East Asia: Structure of Exports



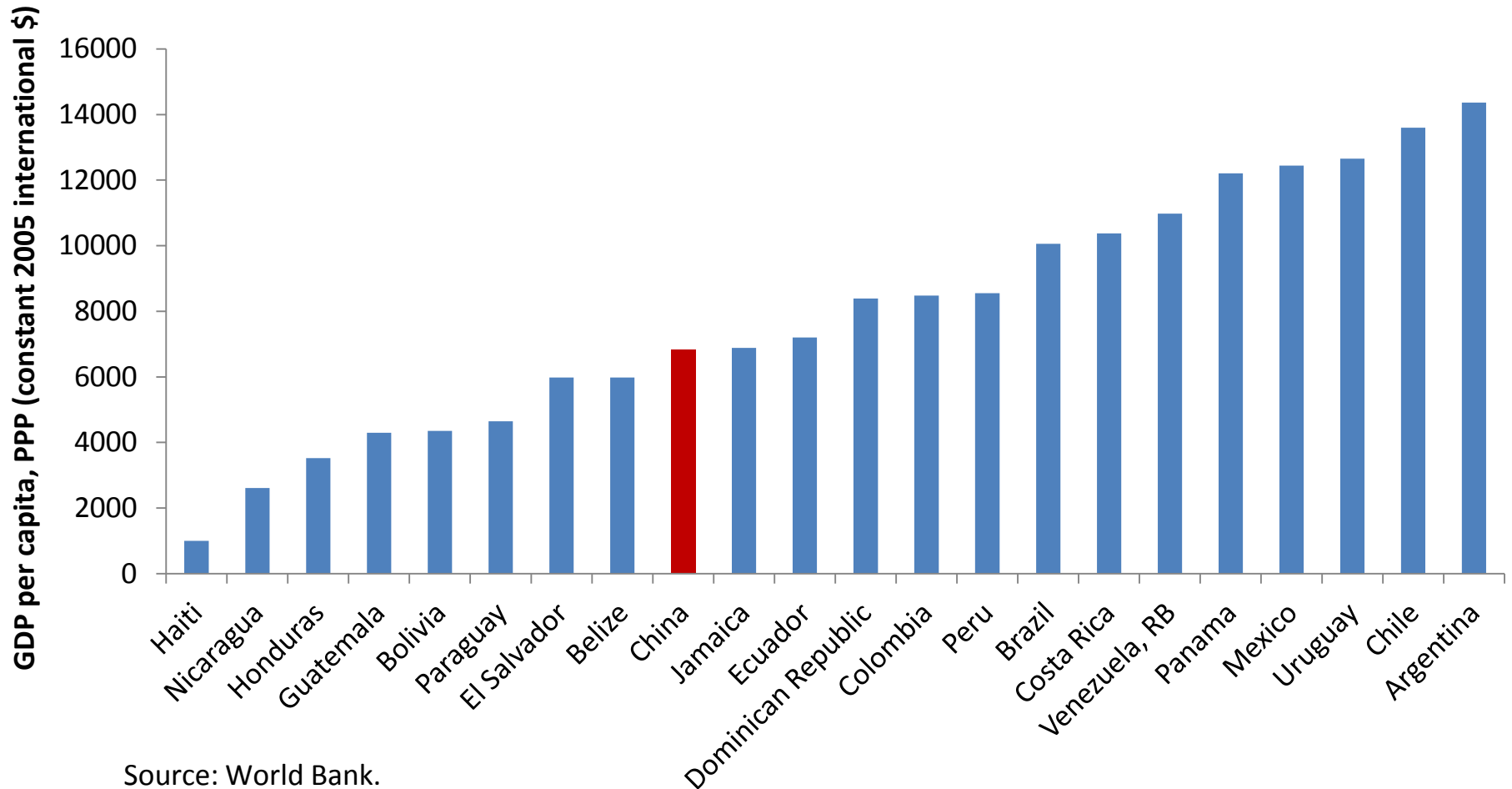
Source: World Development Indicators.

The Opportunities and Challenges of the Rise of China

The Rise of China and LAC

- China's performance since 1979
 - An average annual GDP growth rate of 9.9%
 - An average annual trade growth rate of 16.3%
- The Opportunity and Challenge to LAC
 - China's dynamic growth has contributed to a global resource boom, which benefits LAC
 - China's export of light manufacturing products causes some LAC countries to lose their light manufacturing sector

Per Capita Income in China and LAC in 2011



Source: World Bank.

Prospect of China's Growth

- China's growth strategy is similar to other East Asian Economies after the reform started in 1979.
 - Develop the industries according to the economy's comparative advantages
 - Tap into the potential of advantage of backwardness in industrial upgrading
- China is likely to maintain another 20 years of 8% growth
 - China's per capita income in 2008 was 21% of the United States, which was at the same level as Japan in 1951, Taiwan in 1975, and Korea in 1977.
 - The average annual growth rate of Japan, Taiwan, and Korea was respectively, 9.2%, 8.3%, and 7.6%

Opportunities and Challenges from China's Future Growth to LAC

- Opportunities
 - The resources boom may be maintained, but the effect may diminish due to the decline of resource intensity of China's future growth
 - The rise of China's wage may give an opportunity for LAC countries whose per capita income is lower than China or at the same level to have a reindustrialization in labor-intensive manufacturing
- The challenges
 - The industrial upgrading in China may cause LAC countries whose per capita income is higher than China to face an increasing competitive pressure on their manufacturing sector

LAC's Development Strategy

- Industrial upgrading and diversification is the only way to get out of the middle income trap
- This is also the best way to cope with the challenges from China's rise
- LAC has tried the structuralist approach and the Washington Consensus but failed to get out of the middle-income trap.
- The issue is how to upgrade and diversify the industries and maintain competitiveness.

**New Structural Economics and Growth
Identification and Facilitation:
Implication for LAC**

New Structural Economics

- Application of a neoclassical economic approach to understand the determinates of **economic structure and its evolution** in development
- **Why do I call this approach New Structural Economics?**
 - By convention, it should be called structural economics
- Add “new” to distinguish it from structuralism
- **Why do I focus on structure?**
 - By nature, economic development is a process of continuous change in the structure of technology, industry, and soft and hard infrastructure in the economy

What Determines Structure and its Change?

- **The main hypothesis.** Industrial structure is endogenous to endowment structure, which is given at any specific time and changeable over time
- **Initial endowments.** Determine the economy's total budgets and relative factor prices at time t .
 - Comparative advantage
 - Optimal industrial structure (endogenous)
- **Dynamics.** Income growth depends on:
 - Upgrading industrial structure
 - Upgrading of endowments
 - Improvements in “hard” and “soft” infrastructure
- *Following comparative advantage (determined by the endowment structure) to develop industries is the best way to upgrade the endowment structure and to sustain industrial upgrading, income growth, and poverty reduction.*

The Market and the State

- Firms maximize profits...choice of technology and industries based on relative factor prices...

Need for a competitive market system

- Industrial upgrading and diversification needs to:
 - Address externalities
 - Solve coordination problems

Need for a facilitating state

NSE and the Failure of Structuralism

- Structuralism advised governments to develop industries that were **too far advanced** compared to their countries' level of development and went **against their comparative advantages**.
- The **firms were non-viable in competitive markets** and required government policy support for their initial investment and continuous operation.
- This led to **rent-seeking, corruption, and political capture**.

NSE and the Failure of the Washington Consensus

- All transitional economies started with many nonviable firms in their old priority sectors due to their **comparative advantage-defying development strategy**.
- The Washington Consensus **failed to recognize that the distortions were endogenous** when advocating for the protection of nonviable firms in the priority sectors and advised the government to eliminate all distortions immediately, which caused **the collapse of old priority sectors**.
- The Washington Consensus also **opposed that government play a proactive role in facilitating firm entry** into sectors consistent with the country's comparative advantages.
- The dynamically growing transitional economies adopted **a dual-track approach**:
 - The government continued to provide transitional support to nonviable firms in the old priority sectors and removed distortions only when firms in those sectors became viable or the sectors become very small.
 - The government facilitated private firms' entry to sectors that were consistent with the country's comparative advantage, which were repressed before the transition.

Industrial Policy in a Market Economy

- Industrial policy is desirable.
 - Contents of coordination will be different, depending on industries.
 - The government's resources and capacity are limited and need to be used strategically.
- To be successful, the targeted industries should be in line with the economy's latent comparative advantages.
- But how to do it?

Growth Identification and Facilitation

Step 1

Find fast **growing countries** with similar endowment structures and with about 100% higher per capita income. **Identify dynamically growing, tradable industries** that have performed well in those countries over the last 20 years.

Step 2

See if some **private domestic firms** are already in those industries (existing or nascent). Identify constraints to quality upgrading or further firm entry. Take action to remove constraints

Growth Identification and Facilitation

Step 3

In industries where no domestic firms are currently present, **seek FDI** from countries examined in step 1, or **organize new firm incubation programs**.

Step 4

In addition to the industries identified in step 1, the government should also pay attention to **spontaneous self discovery** by private enterprises and give support to **scale up successful private innovations** in new industries.

Growth Identification and Facilitation

Step 5

In countries with poor infrastructure and bad business environments, **special economic zones or industrial parks** may be used to overcome barriers to firm entry, attract FDI, and encourage industrial clusters.

Step 6

The government may **compensate pioneer firms** identified above with:

- Tax incentives for a limited period
- Direct credits for investments
- Access to foreign exchange

Applying the GIFF to LAC

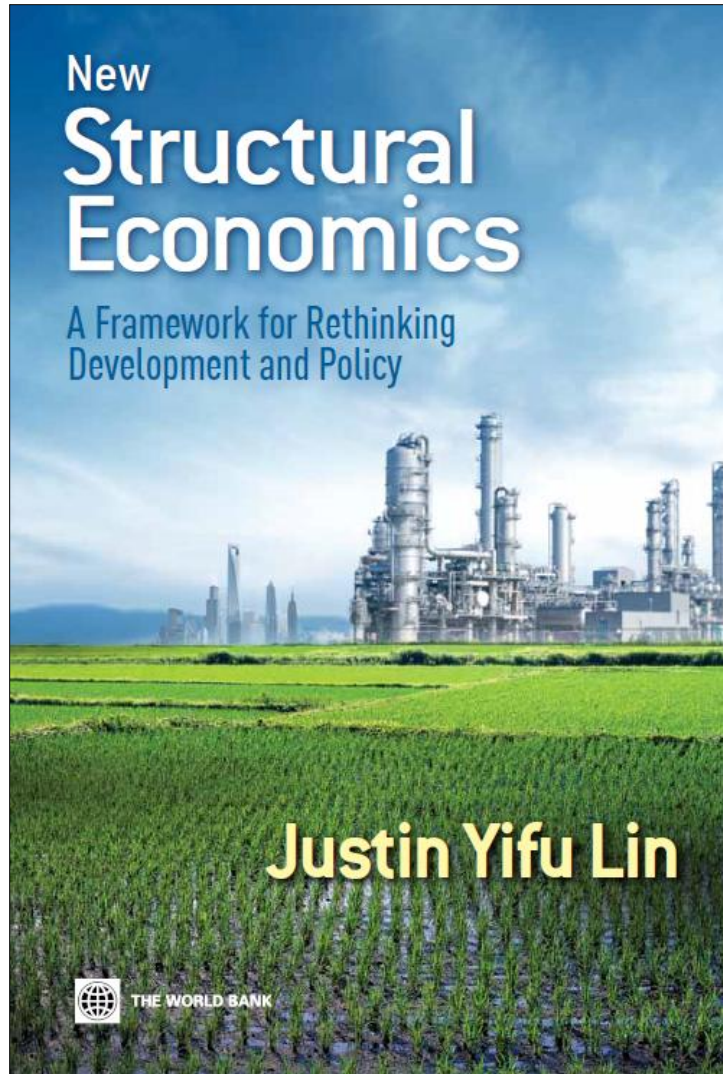
- Countries in LAC are middle-income countries.
- For a middle-income country, most of their industries are still within the global technological frontier but some may be on or close to the global technological frontier
- For the former industries, the six steps in the GIF framework are useful for identifying the new industries and help remove their binding constraints
- For the latter, firms in the industries need to generate continuously new technologies and new products—thus advancing the frontier. The government can use the same approach as commonly used in the advanced countries to support their innovation and upgrading, including patents, supporting for related basic research, government procurement and mandate

Two additional points

- Agricultural development is crucial for developing countries:
 - For poverty reduction, and
 - For providing capital and a market for industrial products.
- A resource-abundant country's resources will be a blessing if:
 - It has a good management of resources. (E.g., some of it must be saved for future generations, and enclave rent capture avoided.)
 - It uses (part of) the wealth generated from resources to facilitate structural transformation.

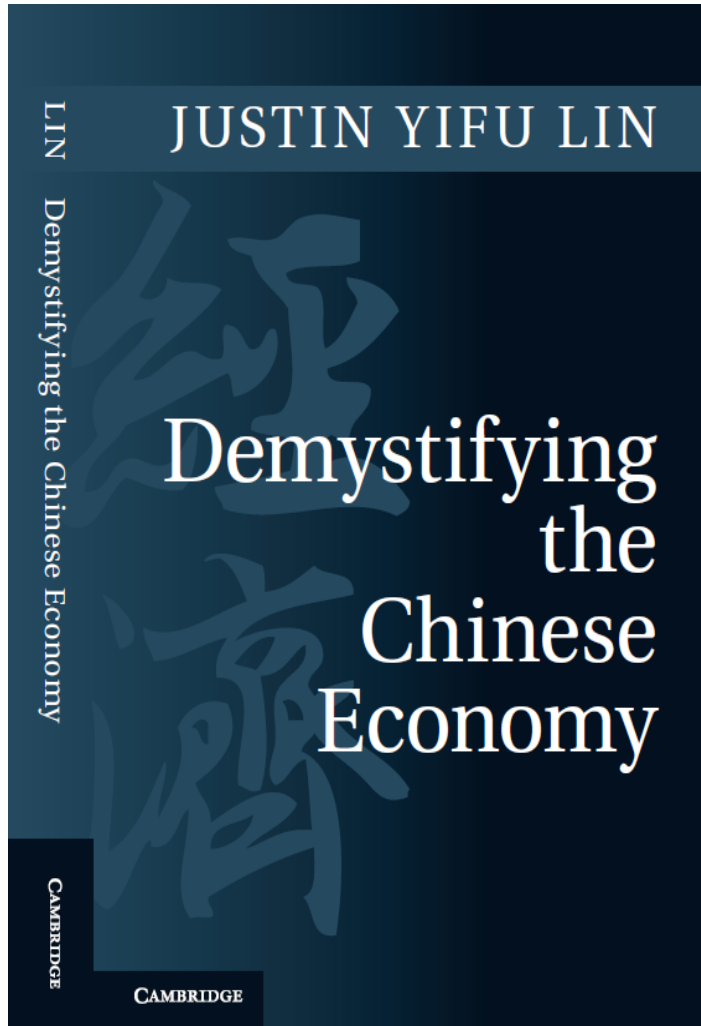
Conclusions

- To avoid further deindustrialization arising from the competitive pressures of the rise of China, broaden the base for economic growth and create the basis for further sustained reduction in unemployment and poverty and improvements in income inequality, LAC's priority needs to be industrial upgrading and diversification.
- Pro-active industrial policy targeted to specific sectors as suggested by NSE and applied in some East Asian countries could facilitate the necessary industrial upgrading.



My ideas are presented in *New Structural Economics*, which can be downloaded for free from the World Bank:

<http://go.worldbank.org/QZK6IM4GO0>



My analysis of China's development is presented in the *Demystifying the Chinese Economy*, published by Cambridge University Press and is available from [Amazon.com](https://www.amazon.com)