China's Rise and Leaving the Middle-Income Trap in Latin America

A New Structural Economics Approach

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China’s Growth Performance

- China started its transition from a planning economy to a market economy in 1979. Since then the economic performance in China has been miraculous：
  - Average annual GDP growth rate of 9.8% with per capita income reaching $6,100 in 2012
  - Average annual trade growth rate of 17%, becoming the world’s factory and the largest exporter
  - 600 million people getting out of poverty
  - Contributing to the growth and the stability in the world, including countries in Latin America

The Challenges that China faces

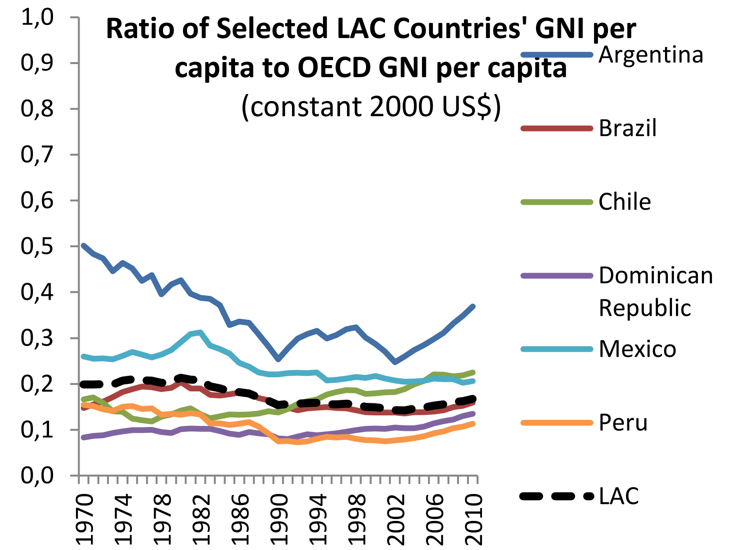
- In spite of its miraculous growth, China faces a series of social, economic challenges:
  - Income disparity
  - Distortions and rent-seeking
  - Environmental degradation
- Most economic problems in China are the results of China’s dual-track, gradual approach to transition

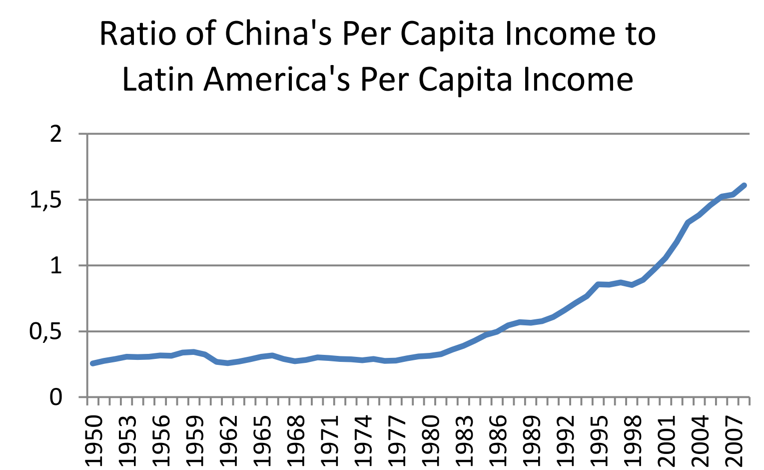
Growth Prospect in China

- If China can deepen the reforms and complete its transition to a well-functioning market, China may be able to maintain another 20 years of 8% growth. This is because
  - China's rapid growth in the past 3 decades was a result of its ability to tap into the potential of advantage of backwardness, similar to the success story in Japan, Singapore, Taiwan Korea
  - The current level of development in China is similar to Japan in the early1950s, Singapore in the mid-1960s, and Taiwan and Korea in the late 1970s. The above four East Asian economies maintained 20 years of 8-9 percent growth from that level of development.

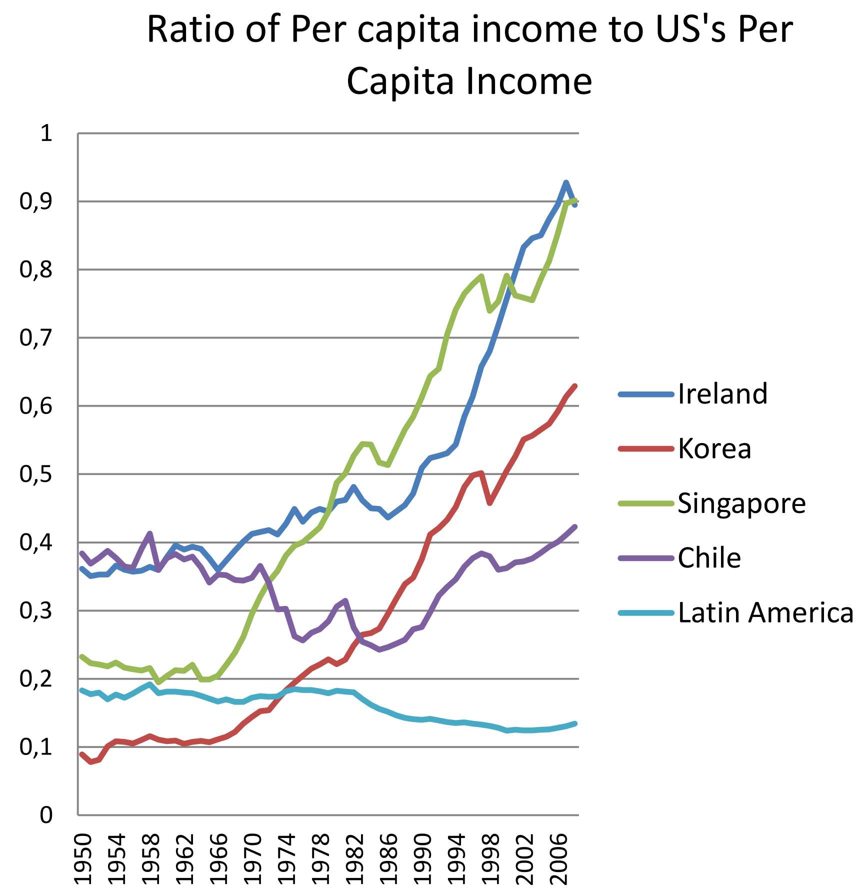
Latin America and the Middle Income Trap

- Latin America started its structural reforms in the 1980s.
- Latin America‘s economy has performed rather well since the beginning of the new century and also during the recent global financial crisis.
- However, LAC’s have remained trapped in the middle-income status.
- As a result, China’s per capita income was less than one third of Latin America’s average in 1979 but becomes two thirds higher than Latin America’s average now.



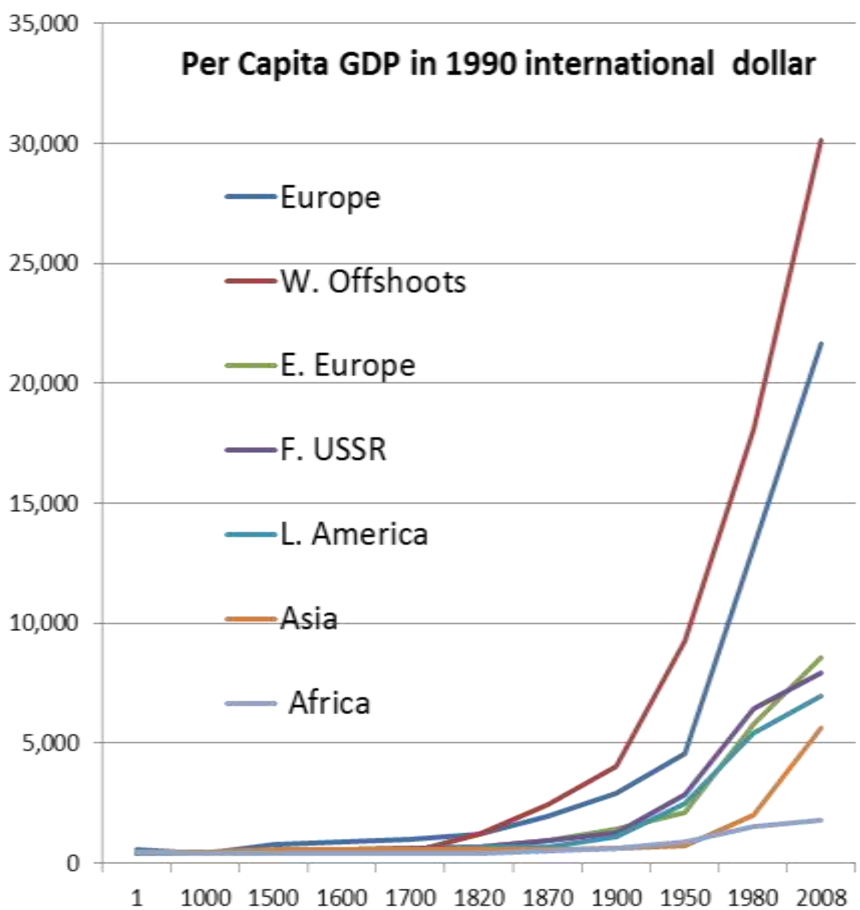


The Middle-income Trap is not a Destiny



- The Middle income trap is not a destiny. Ireland, Korea and Singapore were able to grow to high-income countries after reaching the middle-income status.
- In the talk, I would like to provide a new structural economics perspective about how to get out of the middle-income trap

The Nature of Modern Economic Growth and the New Structural Economics



- A sustained dynamic growth is a modern phenomenon emerging after the industrial revolution in the 18th century in Europe.
- The nature of modern economic growth is a continuous structural transformation in technology, industry and hard and soft infrastructure so as
  - To increase productivity
  - To lower transaction cost
- The new structural economics applies the neoclassic approach to study the nature and causes of modern economic growth.
- The low or middle-income trap is caused by the failure to have a sustained structural change in an economy

The New Structural Economics and the Recipe of Success

- **The main hypothesis of new structural economics**: Industrial structure is endogenous to endowment structure, which is given at any specific time and changeable over time.
- **Initial endowments d**etermine the economy's total budgets and relative factor prices at any specific time, which in turn determine the economy's:
  - Comparative advantage and
  - Optimal industrial structure (endogenous) at that specific time
- **Dynamics**. Income growth depends on:
  - Upgrading industrial structure, which in turn depends on
  - Upgrading of endowment structure.
  - The upgrading of industrial structure requires improvements in "hard" and "soft" infrastructure to reduce transaction costs
- *The recipe of success: 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 institutions needed for economic success

- 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***

Industrial policy is a useful instrument for a facilitating state

- Contents of coordination may be different, depending on industries.
- The government's resources and capacity are limited. The government needs to use them strategically.

Comparative Advantage Defying and the Failure of Industrial Policy

The sad fact is that almost all governments in the world attempted to use industrial policies to play the facilitating role, but most failed.

The reason is that their governments targeted industries that went against their comparative advantages.

- The firms in the industrial policy's targeted sectors were **non-viable** in the competitive market.
- To support its initial investment and to ensure the firms' continuous operation, governments supported the non-viable firms through all kinds of subsidies and protections.
- Those measures led to a lack of competition and increased rent-seeking.
- As a result, the attempts to pick winners ended up picking losers.

Latent Comparative Advantage and Picking Winners

- For an industrial policy to be successful, it should target sectors that conform to the economy's latent comparative advantage:
  - The latent comparative advantage refers to an industry that the economy has low factor costs of production but the transaction costs are too high to be competitive in domestic and international markets
  - Firms will be viable and the sectors will be competitive once the government helps the firms overcome coordination and externality issues to reduce the risk and transaction costs.
- But how can the government pick the sectors that are in line with the economy's latent comparative advantages?

What Can Be Learned From History?

- Historical evidences show that successful countries in their catching-up stage all used industrial policies to facilitate their industrial upgrading and their industrial policies targeted industries existing in dynamically growing countries with a similar endowment structure and moderately higher per capita income:
  - Britain targeted the Netherlands' industries in the 16th and 17th centuries; its per capita GDP was about 70% of the Netherlands'.
  - Germany, France, and the USA targeted Britain's industries in the late 19th century; their per capita incomes were about 60% to 75% of Britain's.
  - In Meiji restoration, Japan targeted Prussia's industries; its per capita GDP was about 40% of Prussia's. In the 1960s, Japan targeted the USA's industries; its per capita GDP was about 40% of the USA's.
  - In the 1960s-80s, Korea, Taiwan, Hong Kong, and Singapore targeted Japan's industries; their per capita incomes were about 30% of Japan's.
  - In the 1970s, Mauritius targeted Hong Kong's textile and garment industries; its per capita income was about 50% of Hong Kong's.
  - In the 1980s, Ireland targeted information, electronic, chemical and pharmaceutical industries in the USA; its per capita income was about 45% of the USA's.
  - In the 1990s, Costa Rica targeted the memory chip packaging and testing industry; its per capita GDP was about 40% of Taiwan's, which was the main economy in this sector.
- Unsuccessful industrial policies, in general, targeted industries in countries where their per capita GDPs were less than 20% of the targeted countries

Why did successful industrial policies target industries in dynamically growing countries with a similar endowment structure and somewhat higher income?

- Industrial upgrading is based on changes in comparative advantages due to changes in endowment structure.
- For countries whose income levels are not too far away, their endowment structures should be not two far away either
- A dynamically-growing country's industries should be consistent with the country's comparative advantages. Some of its industries will lose comparative advantage as the country grows and its endowment structure upgrades. Those "sunset" industries will become the latent comparative advantage of the latecomers.
- For countries with a similar endowment structure, the forerunners' successful and dynamic industrial development provides a blueprint for the latecomers' industrial policies.

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.

Avoid the government doing the wrong things or being captured by vested groups for rent seeking

Incorporate the idea of tacit knowledge

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

Import or cultivate tacit knowledge

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**.

Benefit from opportunities arising from new technologies

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

Play the coordination function in a pragmatic way

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.

Address the externality issue

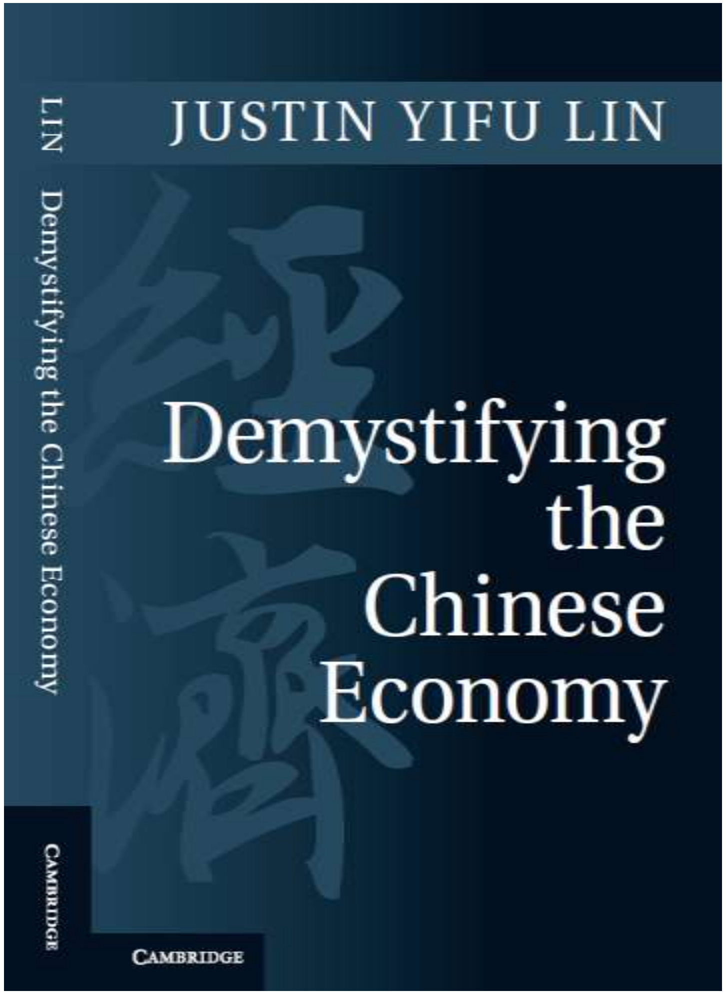
Step 6

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

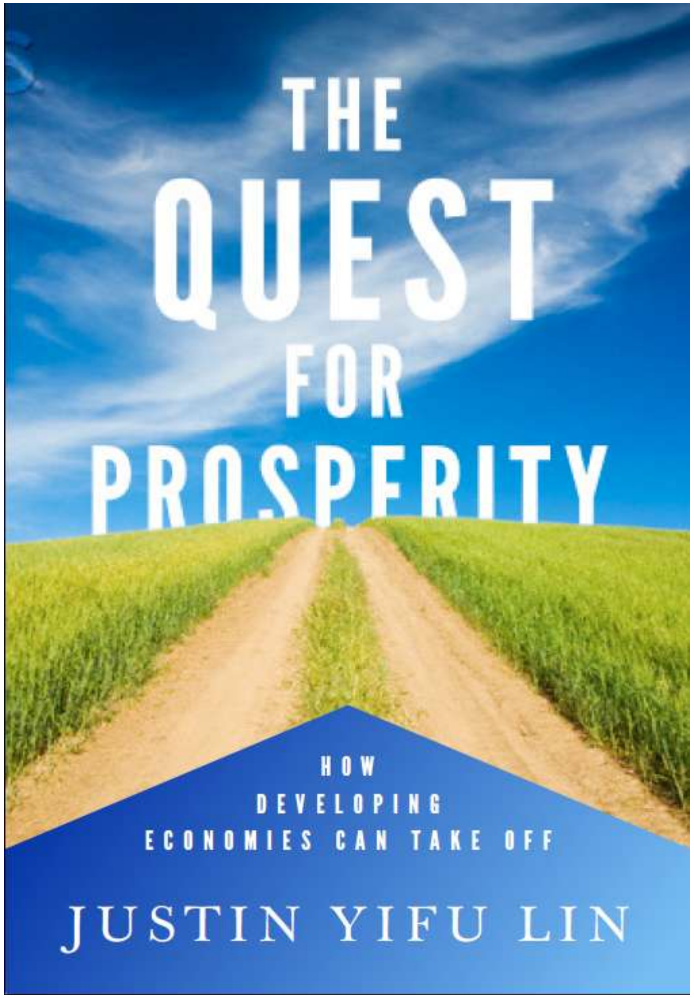
- Tax incentives for a limited period
- Direct credits for investments
- Access to foreign exchange

Conclusions

- The likely dynamic growth in China in the coming years will be a blessing as well as a challenge to Latin America.
  - It will continue to benefit Latin America's export in commodities
  - It will put a competitive pressure on many of Latin America's existing manufacturing sectors
- 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.
- If the policy framework is right, Latin America should also have the possibility to grow at 8% continuously for several decades, get out the middle-income trap and become high-income countries.



This book was published by Cambridge University Press and is available on Amazon.com



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