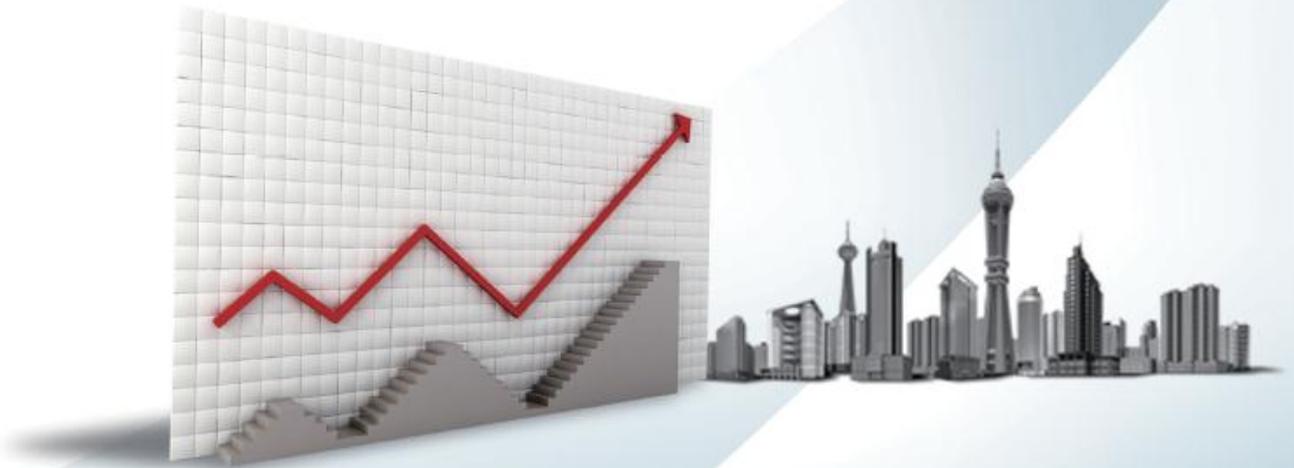




# CHALLENGES OF THE MIDDLE-INCOME COUNTRIES SEOUL DEBATES 2013



*Empowered lives.  
Resilient nations.*





CHALLENGES OF THE  
MIDDLE-INCOME COUNTRIES  
SEOUL DEBATES **2013**



*Empowered lives.  
Resilient nations.*



SEOUL, REPUBLIC OF KOREA

DECEMBER 2013

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The global development agenda is of growing importance to the so-called middle-income countries (MICs). In the first place because in the current debate, paradoxically, they risk to get outside of the table; they are now considered, because of having reached a certain level of development, to be in a less problematic and less urgent situation than the least developed countries. On their side, the middle-income countries contest the validity of the MIC as a category, pointing to the rich diversity of countries that it is assumed to cover and to the persistence of a variety of development challenges, in such fields as inequality, vulnerability, lack of competitiveness and innovation or institutional weaknesses. In other words, MICs refuse to be treated as a single group or category and demand to be part of the international development debate as any other developing country. They are interested in policy dialogues and in some cases in reliable policy guidance for addressing the obstacles sometimes referred to as the ‘middle-income trap’.

The MICs debate is therefore both about problems of definition and of policy implementation. When it comes to definition, the UNDP’s Multidimensional Poverty Index (MPI)<sup>1</sup> is a noteworthy contribution, as it identifies multiple deprivations at the individual level in education, health and standard of living, going beyond the ‘mono-dimensional’ income-per-capita definition of the MICs. In other words, it reflects much better the MICs development challenges. UNDP is also at the forefront of addressing policy implementation challenges through activities on the ground in developing countries and with development partners.

Obviously, Korea has overcome most of these challenges through the different stages of its development, and therefore is invited to be at the forefront of this policy dialogue. In addition, Korea, as the host of the Busan High Level Forum on Aid Effectiveness in 2011, as an initiator of the Global Partnership, and as a key actor of its implementation, can legitimately make its voice heard in this discussion. This is particularly important in the run up for the Ministerial-level meeting of the Global Partnership for Effective Development Co-operation, next year in Mexico.

This report is therefore a contribution to a comprehensive approach on the issue of the middle-income countries. Throughout 2013, thanks to the crucial collaboration with the *Ministry of Foreign Affairs of Korea* and the *Korea Institute for International Economic Policy*, recognized experts and development practitioners from around the world were able to discuss the main issues that MICs are facing, harnessing policy dialogue to the question of the MICs as part of the global development scene.

UNDP will continue collaborating with Korea as a provider of useful policy implementation experiences and knowledge sharing with MICs and a frontrunner of the global debate on development co-operation. There is no doubt that sharing how some countries have already addressed or are addressing middle-income countries challenges and exploring relevant policy options can be beneficial to all development actors. Changing the understanding of poverty and hence the effective fight against it is of equal importance.



**Alvaro Pinto-Scholtbach**  
**Director a.i. (2013)**  
**UNDP Seoul Policy Centre**

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<sup>1</sup> See Annex for more information on the Multidimensional Poverty Index

The Outcome Document of the 68<sup>th</sup> UNGA MDG Special Event held in September recognizes specific challenges faced by many middle-income countries (MICs). It echoes growing global attention toward the development issues of MICs within the Post-2015 context. Acknowledging that a majority of the world's poor now live in MICs, the international community has become aware that solving the challenges faced by MICs, while not impeding the development progress of LDCs, is key to achieving MDG acceleration and the upcoming future development goals.

When Korea hosted the Busan High Level Forum on Aid Effectiveness two years ago, world leaders recognized the special role of MICs, and more than one half of the countries that endorsed the document had middle-income status. Korea considers MICs as the most desirable partners for improving the aid effectiveness of traditional development assistance, and for facilitating South-South and triangular cooperation, since they are both providers and consumers in the new development landscape.

MICs are also a category of particular significance for Korea in terms of its knowledge-sharing in the development field. Starting in the 1960s as one of the poorest countries in the world, Korea underwent intermediate stages of development, to become a net donor in 2009. In the process, Korea managed to overcome a number of development challenges, so-called 'middle-income trap.' Indeed, a number of MICs find themselves 'trapped' in a situation where they are no longer able to compete with countries producing labor intensive goods, nor are they competitive enough to produce high value-added goods. The widening income gap is causing social unrest. Korea achieved inclusive economic growth by maximizing the use of the limited resources of development assistance and actively investing in domestic development. Korea's will is therefore to seek ways to provide MICs with models and practices to assist them in their efforts to make steady progress up the development ladder.

With this in mind, the Ministry of Foreign Affairs of Korea is proud to support its recent series of projects in relation to the MICs agenda. The MIC workshop in May was held in a timely manner, and the result is well reflected in this report. The report describes topics which are crucial to MICs, such as key challenges of MICs and the inclusiveness in the MICs global agenda. It also includes relevant outcomes of the Busan Global Partnership Workshop, which was jointly organized by Korea and UNDP SPC in November 2013. I expect these findings to constitute valuable assets for preparation for the Mexico High Level Meeting of the Global Partnership next year.

Delighted to see the insightful knowledge and policy advice gathered from this process, I look forward to the continuation of such engagement in the global development debate.



**Youngju Oh,**  
**Director General for Development Cooperation Bureau**  
**Korean Ministry of Foreign Affairs**

In the field of international development today, the role of middle-income countries is changing rapidly. The last decade has seen more than 20 poor countries become reclassified as middle-income countries. Having moved up from the low-income countries bracket relatively recently, many of these countries are holders of valuable development knowhow and experience. The recent development experiences of many MICs are valuable assets that can be shared with lower-income countries through south-south cooperation and triangular cooperation.

Nonetheless, we should not forget that MICs also contain large populations of poor people that were excluded from the benefits of economic growth. Each country has its own problems with respect to sustaining the current growth rate and moving further. The most typical challenges facing MICs are inequality and distribution, maintaining competitiveness, welfare, economic and financial crises, and last but not least, negative impact of climate change.

Korea's experience is unique among countries of the world. Building itself up from post-war devastation in the 1950s, Korea has emerged as a global competitor with abundant human resources and sophisticated technology in just over half a century. While global development aid fell by 4% in 2012 amid the continuing financial crisis and budget tightening among traditional donors, Korea was one of nine donors that increased its aid compared to the previous year. There is a growing interest in the international community expecting Korea to share its knowhow and experience regarding successful transformation from a war-stricken LDC to a model of a successful developmental state.

In this report, I recognize the excellent contributions of high-profile experts from Korea and around the world, bringing together their perspectives on the roles of middle-income countries in development. Notably, the May 2013 experts meeting on MICs common challenges was key in setting the right space for future policy consultation, by successfully discussing some of the key common issues that MICs are facing. It gave the initial impulse toward exploring policy solutions to address those challenges and advancing the debate on the MIC in global development co-operation.

I am confident that Korea will be able to transfer some valuable lessons through its past experience, contributing to the development of middle-income countries and beyond.



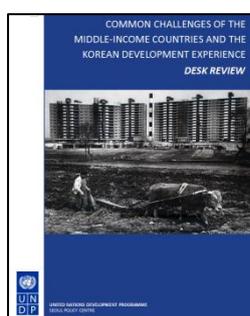
**Dr. June Dong Kim**  
**Director of the Department of International Cooperation Policy**  
**Korea Institute for International Economic Policy**



This report is consolidating the work on the middle-income countries (MICs) which has been carried out in 2013 by UNDP Seoul Policy Centre, in collaboration with the Korean Ministry of Foreign Affairs (MOFA) and the Korea Institute for International Economic Policy (KIEP).

It harnesses the initial work on the middle-income countries common challenges to the current debate on the middle-income countries in development co-operation, in the run up for the Ministerial-level meeting of the Global Partnership for Effective Development Co-operation. It is composed of three chapters (see p.135 for detailed table of content):

**CHAPTER 1 – The UNDP Seoul Policy Centre’s Desk Review: Common Challenges of the Middle-Income Countries and the Korean Development Experience**



pp. 11 - 44

Middle-income countries are encountering certain specific challenges to development. The identification of these challenges and of countries which have faced and overcome similar challenges can serve as a relevant basis for future policy work on the MICs.

This Desk Review is the result of a mapping process, initiated in 2012, which identified a number of key common challenges that MICs are currently facing, using Korea’s development experience as a reference point.

It focuses most particularly on the challenges to structural transformation, economic growth and development inclusiveness.

**CHAPTER 2 – Key products from the Experts Meeting on the Middle-Income Countries Common Challenges**



pp. 45 - 108

A multi-disciplinary meeting of eminent experts from around the globe was organized in Seoul on 13-15 May 2013, by the UNDP Seoul Policy Centre and the Korea Institute for International Economic Policy. It paved the way to a series of international policy dialogues on key common challenges of middle-income countries.

Experts reviewed the main common challenges that MICs are facing, focusing on inequality, welfare and social policy; inclusive growth and competitiveness; economic and financial crises and climate change and green growth.

This chapter includes the key outcome documents and the background papers that participants drafted for the occasion.

**CHAPTER 3 – Key products from the MIC Sessions of the Busan Global Partnership Workshop Implementation strategies for effective development co-operation at country level**



pp. 109 - 130

The MIC categorization is gaining increasing importance in the run up for the ministerial-level meeting of the Global Partnership for Effective Development Co-operation, that will be held in Mexico in April 2014

During this workshop, organized by UNDP Seoul and MOFA, policy-makers and practitioners from over 30 countries considered key deliverables and messages to feed into the ministerial-level meeting.

This chapter includes a background paper on the MIC categorization, as well as the report from the MICs Session giving key recommendations on how to address the MIC category in the development co-operation debate.

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We thank all involved individuals and parties in contributing to our efforts.

The report preparation team





## CHAPTER 1

# COMMON CHALLENGES OF THE MIDDLE-INCOME COUNTRIES AND THE KOREAN DEVELOPMENT EXPERIENCE

## *DESK REVIEW*



UNITED NATIONS DEVELOPMENT PROGRAMME  
SEOUL POLICY CENTRE

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## Common Challenges of the Middle-Income Countries and the Korean<sup>2</sup> Development Experience:

### Desk Review

Increasing importance is being placed on the role of knowledge sharing in development policy. Notably, the 2011 4<sup>th</sup> High Level Forum on Aid Effectiveness stressed the importance of South-South and multilateral cooperation, emphasizing the central role of new developmental actors including emerging donor states in creating, sharing and applying knowledge in development. Particularly, the issue of the middle-income countries (MICs) has become increasingly central in the development cooperation debate, in the run up to the Ministerial-level meeting of the Global Partnership for Effective Co-operation” in 2014. Middle-income countries are encountering certain specific challenges to development and could greatly benefit from insightful knowledge sharing and policy advice from countries which have faced and overcome similar challenges. Possible reevaluation of the MIC category on the global development scene should take into account those specific challenges.

This research represents one dimension of the methodology laid out in the October 2011 UNDP Seoul Policy Centre concept note: “Planning for Development in the Context of Middle-Income Countries: Challenges and Opportunities,” and serves as exploratory research for future Seoul Policy Centre strategic engagement on development issues in middle-income countries by identifying common development challenges shared by some middle-income countries and by drawing on Korea’s own experience with similar challenges.

In May 2013, a multi-disciplinary meeting of eminent experts from around the globe was organized in Seoul by the UNDP Seoul Policy Centre and the Korea Institute for International Economic Policy, to tackle the common challenges of the MICs. A number of additions were suggested and integrated to the present Desk Review, which will serve as a base document for further steps toward systematic engagement and policy dialogue with middle-income countries and other development partners

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<sup>2</sup> Throughout this Desk Review, Korea/Korean or South Korea/ South Korean will refer to the Republic of Korea (ROK) and its nationals.

## I. Introduction

This brief desk review intends to provide a non-exhaustive ‘mapping’ of central challenges to development faced by middle-income countries (MICs), as well as to identify policy points of interest for MICs from the Korean development experience.

We will provide a review of the literature on middle-income countries with the goal of providing insight on three main questions: 1) what are the main common developmental challenges facing MICs today, and what specific conditions bring them about? 2) How and under what conditions has Korea, in its MIC stage, met these challenges? And 3) what implications for MICs can be drawn from the Korean development experience?

We will explore on what issues and to what extent the Korean development can give useful policy lessons to MICs today. By overviewing the Korean responses to developmental challenges we will be able to propose further studies and angles of comparison between Korea and MICs, in order to understand what viable policy options exist to cope with the developmental challenges particular to middle-income economies and societies.

Middle-income countries face two essential challenges to development. The first is a challenge to economic resilience and growth; in an increasingly interconnected world, middle-income economies find themselves on one hand no longer able to compete with the cheap inputs of lower-income exporters, but on the other hand not able to compete with the high-technology production of higher income countries.<sup>3</sup> The second is the challenge of inclusiveness; for many countries, entering the middle income category has been accompanied by an increase in disparities of both income and access to basic needs and services, as well as a change in patterns of consumptions (ODI 2004a).<sup>4</sup> They need to find the right structures, policies and financing for socially and environmentally inclusive development.

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<sup>3</sup> The Straight Times. “Rising Asia and Risk of Middle Income Trap” 24.06.2011.

<sup>4</sup> Of course in addition to being a byproduct of growth, inequality also poses a threat to continued growth. This suggests that sustainable inclusive growth must go beyond treating inequality proper and also focus on changing the patterns of growth which foster inequality. See Tilly 2004 and Easterly 2007.

## II. Definitions and rationale

The term middle-income country as defined by the World Bank refers to any country with a GNI per capita in 2012 US dollars in between US\$1,035 and US\$12,616. The group is further divided into lower-middle income countries (in the US\$1,035–US\$4,035 range) and upper-middle income countries (in the US\$4,036–US\$12,275 range). The World Bank currently classifies 103 countries as middle-income.<sup>5</sup>

The middle-income country category is sometimes **disputed**. MICs are by definition grouped according to income, which does not necessarily reflect a certain level of economic, political or social development. MIC is therefore a very broad and heterogeneous category. Even the division between lower-middle and upper-middle income countries is artificial, since even within these divisions there are countries at different stages of development. Notably, progression of the MICs is not linear and the idea of graduating from low-income to middle-income status can be misleading (Glennie 2013). It does not come, for example, with any significant decrease in poverty. Taking into account the specificity of each country is of the utmost importance when it comes to discussing policy at the country level (Kingstone, 2013).

However there are **reasons** for using the category of middle-income country. The first reason is that many emerging economies and societies can be said to encounter groupings of similar development challenges which are aligned with their level of income. In this case examining similarities in different country contexts can provide valuable insight into development policy. The second reason is that MIC is a category of convenience. Existing research and literature gives consideration to MICs as a category, and identifies certain development challenges as belonging to a '**middle-income trap**'. A core characteristic of the middle-income trap is the fact that, in the current global context, countries on the one hand have wages that are too high to remain competitive in the production/export of labor-intensive, standardized commodity production, while on the other hand productivity is not high enough to allow them to compete in more technology-intensive production (Ohno 2013). The third reason is that the MIC category poses development challenges in a logic of progression. The category suggests the possibility of attaining high-income country status and gears policy recommendations towards this concrete future objective.

Middle-income countries play a crucial role on the current global development scene. Over the last 20 years, global competition has intensified dramatically, the speed of technological change has increased, product cycles have come shorter, and China has become a fierce competitor in low-technology and high-technology goods. MICs seem to have done rather well during the 2000s, as they reversed the long trend of income divergence with high-income countries, and they recovered much better from the global crisis than Japan, the US, and the EU. But appearances are deceiving. Not all growth is created equal (Paus, 2013) and in the most recent period, there has been a reduction in growth rates in most MICs as well as in advanced countries. China's growth rate has fallen from 12.7 per cent in the year 2006 to 7.9 per cent in 2012. Brazil's rate has fallen from 4 per cent in 2006 to 2 per cent in 2012 (Singh 2013). MICs role in the **development cooperation** debate is

<sup>5</sup> <http://data.worldbank.org/about/country-classifications/country-and-lending-groups>

also increasing, as “non-traditional” sources of development finance continue to proliferate, including South-South Cooperation (Glennie 2013). The debate on its growing role as an emerging donor goes together with the debate on its role as aid recipient.

Reference to Republic of **Korea**’s development experience of the past decades is essential to our Desk Review, as it can serve as one of the reference points in the current debate on policy choices. In 1960 South Korea was one of the poorest countries in the world, with a per capita income of about one-hundred US dollars. Its economic prospects were regarded as being so unpromising that the US congress recommended the country should be given humanitarian aid rather than the normal foreign aid for economic development. However, in a mere 30 years the country catapulted into the ranks of OECD countries and within the space of 50 years it has achieved a per capita income of twenty thousand US dollars (Singh 2013). Korea became the first nation that transitioned from an aid recipient to an OECD’s Development Assistance Committee member aid donor in 2009 (Lee, 2013).

Reference to Korea will focus primarily on its middle-income stage which can be set, according to the World Bank classification, approximately between 1977 and 1996.<sup>6</sup> However, we shall not limit ourselves to this particular period. For example, the way Korea dealt with the Asian economic crisis of the late 1990s and its current engagement on the Green Growth agenda can also draw important lessons for the middle-income countries.

The goal of this review is not to suggest any one set of policies from Korea’s past to be adopted. Rather, we will introduce the conditions under which Korea faced certain development challenges and detail the merits and demerits of its main policy responses. In so doing, we aim to give further insight into the underlying causes of certain MIC challenges and provide a sample of the menu of available policy responses.

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<sup>6</sup> During the 1997 financial crisis Korean GNI per capita dipped below the US\$12,275 mark, and came back up again in 2002.

### III. Structural transformation & Economic Growth

#### 1. Economic and financial vulnerability

Middle-income countries face increased **vulnerability to economic and financial openness**. Middle-income countries which expose themselves to global flows of goods and capital without proper safeguards run the risk of being affected more by global crises. An oft-cited example of this is the different impact of the 1979-82 debt crisis on Latin American and East Asian countries. In the former case increased capital flows into the region coupled with large-scale borrowing from the 1960s onwards increased state debt, while soaring oil prices and reduced global demand for primary goods made it all the harder for most Latin American countries to recover, and ultimately earned the 1980s the title of 'lost decade' of development for the region (Calomiris 1999; Stallings, 2004).

The challenge of financial vulnerability is characteristic of those MICs which have liberalized their financial markets in order to gain easier access to capital. With the global economy recovering from the financial crisis, capital is flowing back to emerging market economies. It is flowing mostly into middle income countries where the capital markets are relatively larger and more liberalized than those of less developed economies. Capital mobility allows countries with limited savings to attract financing for productive investment projects (Yoon 2013). To confront more complex development challenges many MICs have expedited reform to modernize their financial sector and increase integration to the global financial markets, as well as adopted a more open and liberal capital account regime (Anglingkusumo 2013). Such reform must include implementation of a strong and coordinated medium term macroeconomic framework so as to reduce risks to financial and macroeconomic stability (World Bank 2010; Van Doorn et al 2010). They are characterized by a lack of flexibility in exchange rates, high debt equity ratios, a lack of regional cooperation for volatility control and weak institutional frameworks to deepen local currency markets (Gill and Kharas, 2007; UN General Assembly 2011; Foxley 2009).

MIC vulnerability is also brought on by the very **economic integration** which can contribute to increased competitiveness. Rapid integration of economies in the global market can have adverse effects for MICs when domestic industries are not sufficiently competitive and when there is a precarious transfer from agricultural to industrial production. In the former case domestic industries unable to keep up with global production fall behind, exposing the population to volatile global commodity markets (Ohno 2009). In the latter case a slow transfer of the workforce into industrial production increases unemployment, which coupled with persistent low wages places the rising industrial workers "only a shock away" from poverty (Martens and McKinley 2011: 17). This precarious economic liberalization is especially evident in India, Thailand and the Philippines (Martens and McKinley 2011).

On the other hand despite similar levels of debt, a trade deficit and falling productivity before and during the 1979-82 debt crisis on Latin American and East Asian countries, Korea was able to recover in a relatively short period of time (Collins and Park 1989a). During the crisis, Korea had secured continued large capital inflows, allowing it to revive growth before undertaking restrictive monetary and fiscal policies (Collins, 1990). Furthermore Korea's financial deregulation up to the mid-1990s was a long and gradual process which happened in the context of large account surpluses in the 1986-1989 period (Park 1996). Korea's 1997 economic crisis generated a number of monetary and

fiscal policies to overcome the weak economic fundamentals of the country and the self-fulfilling nature of the crisis. The corporate sector reform involved restructuring insolvent firms and strengthening market discipline to prevent future crises. The financial sector reform focused on quickly normalizing the financial system through restructuring, and rebuilding a financial safety net to prevent future crises. To reform the labor market, large-scale layoffs of redundant workers, including in the public sector which experienced large-scale privatization (Lee, 2013).

Middle income countries turning to increased financial and economic openness in order to stimulate growth and expand markets can learn from the Korean experience; most importantly an in-depth look at the macro-economic policies that marked Korea's pre-debt crisis period would provide insight into how to avoid the brunt of crises stemming from increased integration into global economic and financial flows. The incomplete financial safety nets of MICs should be complemented and improved continuously on a globally coordinated effort. Financial policymakers should assure the accessibility when they are in need, the sufficiency of the amount available to cover problems, the absence or reduction of stigma effect and of moral hazard (Yoon 2013). MICs have to ensure all banks (and also all non-bank financial institutions) are strong and healthy. They also need to manage the pace of further liberalization of the financial markets and to balance it against the risk of interconnectivity of domestic financial markets with global financial flows. Lower MICs also need to implement a consistent macroeconomic policy framework with multiple instruments, including the traditional market based interest rate instrument and administrative measures such as statutory reserves requirement, for absorbing the excess liquidity generated by the capital inflows (Anglingkusumo 2013).

## 2. Growth and productive capability advancement

One main challenge to growth and competitiveness for MICs is **industrializing while gaining in productivity**. This is when economies in transition to industrial production experience a sharp fall in the share of agriculture or primary production without experiencing a commensurate rise in secondary sector productivity. This is the central logic behind the ‘middle-income trap’ (Ohno 2011). This industrial upgrading, which tends to occur as countries enter the MIC stage, shifts the economy from labor-intensive to technology-intensive production, driving up wages and driving down competitiveness (World Bank 2012a). Economies are unable to properly mobilize technical skills to increase productivity for two reasons. The first is that the growth in industrial production is spurred in most cases by an influx of small and medium enterprises which decrease overall productivity (Cervantes-Godoy and Brooks, 2011). These firms are not sufficient to drive growth in technical skills (Ohno 2009). Over the last 20–30 years, many middle income countries, particularly in Latin America, have seen productivity-reducing structural change, where labor has moved to activities with lower productivity (Paus, 2013). The second reason is that industrializing countries are often outpaced by regional powerhouses. China for example absorbs a large portion of cheap labor-intensive industry, creating a barrier to entry by its low wages and scale (Chandra et al. 2012), even though, in some cases, regional powerhouses pull up other neighboring countries.

Countries just graduating into the MIC bracket usually benefit at first from factor accumulation in the secondary sector, which drives growth (this is the case of Korea, Nigeria and Egypt in the 1960s and 1970s for example) (KDI 2011a). However growth in industry is not sustainable without gains in total factor productivity (Satoru 1997). While Egypt and Nigeria saw wage increases adversely affect productivity (Kheir-El-Din 2005), Korea’s attention to productivity through its policies and **institutions** enabled it to sustain a productivity increase in value added terms of 3.3% from the 1970s to the 1990s (KDI 2011a). Firstly, Korea established the Korean Productivity Center in the late 1950s with the sole goal of increasing productivity. This institution was allowed to play a central role in economic policy planning, enabling productivity growth policy to be incorporated in long-term economic planning (KDI 2011a; Hak 2005). On the **policy** side, Korea took advantage of favorable international conditions in the mid-1980s to encourage investment in industry which directly resulted in increased productivity (Satoru 1997). However Korean policy **setbacks** may also provide valuable policy lessons to MICs. The 1973-79 “big push” that concentrated export production in heavy chemicals also drove up wage growth and inflation, hurting productivity (Collins and Park 1989a). Productivity is of course affected by a myriad of factors including education, technology accumulation and economic openness (Adenikinju 2005). However Korea’s productivity-specific institutions and policy focus may provide interesting policy lessons to those MICs starting to experience rapidly increasing industrial production and rising wages.

One essential challenge to competitiveness is in **establishing suitable institutions for industrial policy**. At lower levels of industrialization, gains in economic growth may be experienced by liberalizing trade and safeguarding macroeconomic balances (Altenburg 2011). Less importance is placed on institutions. Growth in several MICs at early stages of industrialization, including China and Vietnam, is argued to have taken place in the absence of properly-functioning institutions (Ohno 2009). However institutions for industrial policy are important for MICs exhibiting any one of three particular challenges. The first is the challenge faced in adjusting production across various sectors to learn what is profitable and feasible, which requires support from the state (Ohno 2009). The

second is when economies with expanding secondary sector production experience a lack of policy coordination among stakeholders in managing investment and growth agendas (Hausman et al. 2008). The third is when the state cannot effectuate an efficient and equitable distribution of public inputs in the form of infrastructure, legislation, and research and development (Altenburg 2011). The research indicates that numerous middle income countries are not able to mobilize industrial policy or institutions to achieve higher productivity and growth (Pack and Saggi 2007). Vietnam is one key example. Economic liberalization and inflows of external purchasing power spurred Vietnam's initial industrial growth since 1986 (Ohno 2009). However these economic reforms came without the institutional arrangements that govern industrial policy; Vietnam is seen as having been unsuccessful in carrying out long-term, action-oriented and inclusive policy due to a lack of proper institutional functioning (KDI 2011b). As a result industry-driven productivity and growth are expected to suffer (Ohno 2009). In contrast the few countries that have seen great successes in industrial policy have also established effective institutions at the same time as economic liberalization. This is particularly the case of Korea and Argentina, where both 'insulated technocratic agencies' (Cheng et al. 1998) and strong private sector stakeholder dialogue when instituted along with, as opposed to after economic liberalization, have contributed to gains in economic growth. This suggests the importance of institutional alignment in tandem with economic liberalization for MICs (Altenburg 2011).

The ability of the state to effectively participate in **coordinating economic activity** presents another important challenge to middle-income countries. Middle-income country economies are especially prey to both falling into low equilibriums in sector productivity and being unable to mobilize investment and entrepreneurial enterprise (Rodriguez-Clare 2005). This is because MICs with a rising skilled labor force but insufficient capital endowments are not able to properly invest in and profit from modern sector production: "it is in the intermediate economies most reminiscent of Korea, [...] well-endowed with skilled labor but poor in physical capital –that the coordination problem is most severe" (Rodrik 1995: 22). The state may thus play a central role in encouraging economic growth. The question of state coordination of economic activity inevitably raises normative debates on state intervention in economic development. It is not within the purview of this review to delve in-depth into this topic. Rather, it is important to note that regardless of its extent and nature, state intervention in some form is seen as desirable in negotiating market and coordination failures by a broad swath of the literature (World Bank 1993; Jomo 2001; Rodrik 2008). Indeed the engagement and effectiveness of the state in its market interventions are identified as important variables in increasing economic effectiveness and spurring growth in less developed countries (Fritz and Menocal 2006; Ohno 2009).<sup>7</sup> It should be however highlighted that policies for the productive sector aimed primarily at correcting market failure are often piece-meal, non-transparent and not well coordinated. More importantly, they do not focus sufficiently on the accumulation of technological capabilities, which allows for broad-based structural change towards higher value added activities and is therefore the driving force behind sustained productivity growth (Paus, 2013).

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<sup>7</sup> An important section of the literature on state developmentalism examines new forms of state intervention in emerging markets. This 'neo-developmentalism' combines state intervention to promote growth in domestic big business and at the same time greatly reduced protectionism in an export-oriented context of economic growth. For further discussion in the Brazilian context, see **Bresser-Pereira 2006; Doctor 2010; Hochstetler and Montero 2012.**

There **are different types** and extents of state intervention (Evans 1989). More successful state attempts at coordinating economic activity have mobilized capital and investments efficiently (World Bank 1993), whereas less successful attempts have been marked by inefficient public sector activity and ineffective state mobilization of the private sector (Woo-Cumings 2001). The state must negotiate its role as independent and unfettered actor (Fritz and Menocal 2006) with a responsiveness to realities affecting society and particularly the private sector 'on the ground' (Rodrik 2007); this duality is best encapsulated in Evans' (1995) concept of 'embedded autonomy.'

The Korean development experience, particularly in its middle-income period, provides valuable insight into the question of state coordination of economic activity despite its incarnating an extent of intervention that is not supported by any recent scholarship. The Korean case is useful in three respects. The first is in its **use of economic and financial mechanisms** to boost investment and direct production from the 1960s to the late 1970s. The state initially offered credit subsidies and tax incentives to private sector companies, directing public investment into enterprises focused on modern sector production and exports (Rodrik 1995). In addition, the state subsidized specialized education, technology and innovation initiatives tailored to private sector needs (World Bank 2006), making use of its control over the country's banking institutions and its National Investment Fund to encourage coordinated private sector investments (Hattori 1997). The overall strategy and the specific policy tools mobilized by the Korean state present MICs with a number of policy options.

The second is in the **variety of roles** that the **state** took on during Korea's MIC period. State direction of industrial production on heavy and chemical industries was very direct in the 1970s, but during the 1980s Korea underwent economic liberalization. By the same token the state placed alternating emphasis on private sector roles in the provision of social services (largely until the 1990s) and state-financed social policies (towards the 1990s, or the end of Korea's middle-income period) (Woo-Cumings 2004). This shift can show the conditions of the transition, the setbacks and policy solutions put forth by the state, and can give insight into the strategies and modalities of shifting away from high state intervention in the economy.

Also at stakes in the middle-income countries is the question of how to relate **export-led policies** to growth. Emerging Middle Income Countries (MIC) has adopted different routes, phasing and timing of strategies and development policies. Usually exports promotion has played a significant role in this process. Many MICs rising on the wave of globalization have moved up rapidly on the ladder of exports and trade, broadening and diversifying their exports market. However, the empirical evidence on the links between exports and growth, is not conclusive (Hill, 1994). While economic growth rate has increased remarkably, poverty and employment remain weak. For countries with large internal market, domestic market rather than exports become major drivers of growth, reducing incentives for efficiency (Adenikinju 2013).

MICs also face challenges in **integrating economic activity**. This particularly affects MICs which have not yet established economies of scale for their export industries and have a wide variety of industries attempting to gain in scale and competitiveness (Gill and Kharas, 2007). These various budding industries may be met with a lack of economic integration which can hinder growth and competitiveness. Firstly there is the lack of vertical integration- industries have little control over supply chains and intermediary goods and so less control over production costs and supply of parts (Gill and Kharas, 2007). Secondly, there is the lack of spatial integration. This is when industries which would benefit from being physically grouped are apart from one another, and so unable to

benefit from economies of agglomeration (World Bank 2009). Lastly there is the lack of regional integration. This occurs when MIC industries are not able to fully benefit from technical assistance or (UN General Assembly 2011) access to capital markets in the region (Fallon et al. 2001).

It is acknowledged that vertical economic integration is not a panacea for economic growth (Robertson and Langlois, 1995). However for middle income economies which are in the process of specializing production, vertical integration is seen as a useful tool (Gill and Kharas, 2007). The East Asian example in particular shows that state-targeted upgrading of global commodity chains in manufacturing was a key element in expanding the technological intensity of production (Harada 2008). In many cases however this requires high initial investments and moderately high technology levels (Kim and Lee 1994).

This also requires a high level of regional integration. The success of Asian countries in achieving vertical integration in manufacturing has also been informed by their successes in facilitating the dynamic specialization of trade on a regional level (Kimura and Obashi 2011). That is, lowering trade barriers and streamlining import and export processes<sup>8</sup> contributes to deepen regional trade networks in unfinished parts and components. This has contributed to increased trade, investment and technological transfer for Asian economies (Thorbecke et. al. 2010). This specialization or ‘trade fragmentation’ has presented industrializing economies in the region with the option of, firstly, developing “niche local advantages” to attract specific types of production in intermediary goods (Kimura and Obashi 2011: 5). Secondly, it has allowed countries to involve SMEs in production networks and upgrade the value added of production. Lastly there is evidence to suggest that increasing trade within the ASEAN network has facilitated technology linkages among countries (Thorbecke et. al. 2010).

The successes of East Asian countries in moving up global production chains were also informed by domestic policies such as spatial integration (Harada 2008). Korea achieved spatial integration for the economy through industrial park planning and development. Korea’s industrial parks were developed in the early 1960s, almost 20 years before its entry into middle-income status. The state directed the construction, location and function of the parks by overseeing construction, providing basic infrastructure and facilitating land acquisition (Kim and Gallent 1997). As a result Korea benefitted from an easier adjustment to challenges faced in the mid to late 1970s, as it became a middle income country. Namely foreign and domestic investment into industry was streamlined, technology transfers were made easier and the needs of industries adjusting to rapid urbanization were taken into account.<sup>9</sup> This suggests that proper integration of economic activity can be a useful tool when implemented before the middle-income stage and in tandem with new industrial growth policies.

**Increasing innovation** is another challenge that MICs face. Wage increases themselves do not harm productivity, if they are accompanied by increase in labour efficiency or overall efficiency of production. However, the limited influence of innovation, technical changes and technological adoption quickly exhaust productivity gains from factor accumulation. Many low-income countries

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<sup>8</sup> A good example of this in Asia is the ASEAN Single Window, a process streamlining information and data submission in the customs clearance process, allowing for more rapid and efficient trade between signatory countries. See Hiratsuka 2008.

<sup>9</sup> An example of this last point is an industrial park built in the capital region specifically to accommodate small and medium enterprises relocating from the city centre. See Kim and Gallent 1997.

accede to middle-income status mainly due to an increase in inputs in the economy, as opposed to an increase in total factor production (Krugman 1994). However in order to increase productivity and competitiveness, gains in innovation are required (Gill and Kharas, 2007). While MICs have been in part able to use foreign technology to move up the global commodity chain (Asian Development Bank 2011), firms from MICs which are either too small or too technologically behind leading firms will often give up on innovation and only focus their efforts on 'catching up' to the leading firms (Gill and Kharas, 2007). Successful middle income countries tend to exhibit three main traits: (1) a significant percentage of local firms has learned to adapt technological knowledge from more advanced countries to the firm and country-specific context; (2) TNC affiliates have started to move away from the assembly of labor intensive, low-tech goods towards production in medium and high-tech goods. And (3), skills training programs and growing/high enrolments at the secondary school level are the key social capabilities in education (Paus, 2013).

MIC industries face two central obstacles to achieving more innovation. The first is the lack of spending on research and development. Higher innovation is correlated to higher growth (World bank 2011). Low spending on research and development and a low share in R&D spending by the private sector adversely affect innovation (Asian Development Bank 2011). The second is the lack of institutional capacity to absorb the existing technology and human capital that contributes to higher innovation. This includes the inability to guarantee a job market to accept a higher educated population, quality institutions for research and higher education, and collaboration between public and private sectors (Gill and Kharas, 2007).

Thailand is one MIC which is struggling to properly mobilize innovation. Falling behind in its income group and in innovation, Thailand's R&D expenditure is the lowest in the region at .025% of GDP. The majority of this amount is spent by the state, with the private sector contributing less than half (OECD 2011a). In addition Thailand has the lowest number of patents per capita in Southeast Asia. Also, despite a state focus on general education, Thailand has not formulated science and technology policies that are integrated with its education policies, and has very limited interaction between its institutions of higher learning and firms (Brimble and Doner 2007; Intarakumnerd and Chaminade 2011). On the other hand Thailand's investment in agricultural innovation has been shown to increase total factor productivity and contribute to boosting export capacity (Suphannachart and Warr 2010). The Thai example highlights both the potential for economic gains via primary sector innovation (Thailand is the world's first exporter of rice) and the constraints imposed by a lack of private sector involvement in research and development. Private sector underinvestment in agricultural innovation (Suphannachart and Warr 2009) and its limited ability to "absorb and implement new technologies emerging from the research pipeline" limit Thailand's ability to pursue higher value-added agricultural activities in the long run (Thitinunsomboon et al. 2008: 99).

The export-led and innovation strategy of Korea is closely linked to the emergence of **big conglomerates** (*chaebols*), and leads to mixed conclusions. From 1962, the autocratic government gave a particular focus to export in formulating the series of Five-Year Economic Development Plans. In the 1960s, the government actively promoted exports of labor-intensive light industry goods of all sectors with generous fiscal and financial incentives (Lee, 2013). Special concessions were given to entrepreneurs and firms only in response to meeting strictly the performance targets set by the government, often export targets. These industries absorbed surplus labor from rural areas and helped increase per-capita income and savings rates of both urban and rural populations. Export

targets involved new products which were subject to huge uncertainty whether or not they would succeed, and state-owned banks bore the risk of innovation through targeted lending to *chaebol* conglomerates (Singh 2013). Therefore, the risks taken on by private capital were socialized through state guarantees on investments or foreign loans (Woo-Cumings 1991). Centrally driven export-led industrial policy in the Korean fashion also engenders state corruption and can foster crony capitalism (Woo-Cumings 2001). Also the state, in favoring the growth of *chaebol* conglomerates contributed to ‘unbalanced growth’, with small and medium enterprises (SMEs) becoming overly dependent on larger entities (Nugent and Yhee 2001). Finally, innovation suffered weak participation by small and medium enterprises and uneven innovation development across sectors (OECD 2009). These problems still affect Korea today, and a careful analysis of the Korean case could reveal possible roles for the state in integrating education, research and industrial policies for innovation while conserving a balance between larger and smaller enterprises. Particular care should be taken among the MICS where investors tend to rely on the state as an emergency source of funding.<sup>10</sup>

Nevertheless, those setbacks should not overshadow the success of Korea’s innovation policies, which have contributed to higher innovation and competitiveness. In addition to the conglomerate strategy, Korea’s policies included a focus on state-funded research institutions starting in the 1960s, before Korea acceded to middle-income status. Then, as Korea became an MIC the state started promoting both university-based research centers as well as providing substantial incentives for private sector investment in research and development.

There are of course **limits** in the extent to which state coordination of the economy in the Korean model can be applied to MICs. MICs usually do not have the same dichotomy between *chaebol*-type conglomerates and SMEs. Also, state interventionism and protectionism realized in the 1970s and 1980s in Korea does not necessarily reflect the realities of today’s globalized free trade regimes. Nevertheless the Korean example remains relevant because it allows for study of the specific policy mechanisms and broad industrial plans orchestrated by the state in the industrialization process. Pro-active government policies are needed for the move to a knowledge-based economy, both at the structural and policy levels. Moving to the next phase of capability accumulation requires the development of a national innovation system, with increasing enrolments at the tertiary level, more specialized technical skills, greater public expenditures on R&D, and greater sophistication of the ICT infrastructure. The advancement of these social capabilities enables growing research and development activities by local firms and a movement of TNC affiliates towards higher value added activities and some R&D (Paus, 2013).

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<sup>10</sup> De Rato, R. “Middle Income Countries: Opportunities and Challenges.” *Emerging Markets*. 03/03/2007. <<http://www.emergingmarkets.org/Article/1244138/Middle-Income-Countries-Opportunities-and-Challenges.html>> <retrieved 01/05/2012>.

## IV. Development inclusiveness

### 1. Social inclusiveness

One of the central challenges related to **poverty** today is that the majority of the world's poor live in middle-income countries. Up to one billion people live in extreme poverty (under \$1.25 per day) with an additional one billion earning between \$1.25 and \$2.00 per day. The primary reason for this rapid increase in the proportion of the world's poor living in middle-income countries is that rapid growth in national income, especially over the 2000s has led to a reclassification of a growing list of former Lower Income countries as Middle Income. In fact, 30 countries, including 5 populous ones, shifted into middle income status in recent years so that as of 2012 only about ¼ of the world's extreme poor live in LICs. For example overall inequality in India has increased sharply in the past two decades, with now 42% of its population living on less than 1.25 a day.<sup>11</sup> China, South Africa and Nigeria are also MICs experiencing increased inequality with economic growth. Not all MICs follow this trend, however. Brazil, Argentina and Indonesia have all recorded reductions in inequality in several indicators.<sup>12</sup> Korea's own low inequality during its middle-income period could offer significant insight into more inclusive growth for middle income countries. However proper policy responses to inequalities rely on an accurate understanding of the causes of inequality, which can vary by country and context.

Not only do the majority of the world's poor inhabit middle-income countries, MICs also have the largest rates of inequality, including **income inequality** (UNICEF 2011). MICs experiencing high inflation and high volatility are especially exposed to increasing inequality of income (Anderson et al 2003). The poor see little to no rise in real income,<sup>13</sup> while large firms and the emerging industries drive up income levels for a certain portion of the population (ODI 2004a). Income disparities in MICs, more so than in other countries, are marked by large horizontal inequalities; social inequalities tied to race (South Africa) gender (Brazil) and rural-versus-urban populations (China) are directly related to inequalities of income (Anderson et al. 2003). In most countries, especially in developing Asia and Africa, inequalities have crossed bounds of social tolerance and have become both economically and socially dysfunctional (Ghosh 2013).

A major part of existing inequalities within countries today results from unequal control over assets. These include natural resources such as land, water, minerals and other fruits of nature, as well as produced productive assets and financial assets. The increasing concentration of all such assets needs to be countered by explicit policies to reduce it and spread the access to resources and assets more equally (Ghosh 2013). Decreasing inequality can contribute to economic growth (Grimalda and Vivarelli 2010).

<sup>11</sup> "India's Income Inequality has Doubled in 20 Years: Report." First Post. 07/12/2011.

<<http://www.firstpost.com/economy/indias-income-inequality-has-doubled-in-20-years-report-150257.html>>  
<retrieved 21/05/2012>.

<sup>12</sup> Ibid.

<sup>13</sup> In many cases the rise in income for the poor is due to an increase in average income (a growth effect) and not an increase of the share of the poor in total income (a redistribution effect). The most prominent example of this growth effect is China, which has seen inequality rise even as absolute poverty continues to decline. See ODI 2004a.

The same is true of Korea during its middle-income period. In Korea's case, the middle 40% of the population's share of income went from 38.9% in 1965 to 38.6% in 1985, while the lower 20% dropped slightly from 19.3% to 17.7% over the same period (KoFID 2011), showing relatively low and stable levels of income inequality. Korea achieved simultaneous economic growth and reductions in inequality during the 1960s, due to both favorable preconditions such as equal land ownership and near-universal primary schooling (Kang 2001; Collins and Park 1989b) but also due to focused employment policies during that period. However the first half of the 1970s was marked by increasing trends of inequality; the growth of the *chaebol* big businesses and state pressure to keep wages artificially low in key export industries played a pivotal role (Rodrik 1995). Additionally, disparities between urban and rural populations grew and increasing urbanization began placing a strain on social infrastructure, contributing to overall income inequality. Korea's Fourth and Fifth Five Year Plan for Economic Growth (1977-1986) responded to an increasing number of studies and statistics pointing out growing social inequality (Collins and Park 1989b). It was a renewed policy focus on inequalities, including controls placed on inflation and allowances for increased wage converging that contributed to reducing inequality subsequent to 1976 (Fields and Yoo 2000). However, income distribution became less equitable in the early 1990s and worsened after the Asian crisis, due to the globalization of the economy that puts low-skilled workers at a greater disadvantage, growing productivity gaps between manufacturing and services, HCs and light industries, and large and small businesses, stagnant employment growth, an inadequate social safety net, and an aging population (Lee, 2013).

MICs face problems of inequality stemming from unequal **social protection** capacities. In developed countries, welfare states have been successful in integrating the provision of basic services, like health and education, with social protection institutions. However, in developing countries, social insurance schemes and employment programmes are limited in coverage. The recent expansion of social protection in the South has concentrated on antipoverty transfers, the social assistance component. Estimates suggest that by 2010 between 750 million and 1 billion people in developing countries lived in households receiving transfers (Barrientos 2013). Policies such as taxation and increased social expenditure have seen some successes (Moore and Schneider 2004) but simple income redistribution is not considered a viable long-term solution (ODI 2004a).

As previously stated, despite a short span of increasing inequality, Korea was able to pursue economic growth and promote relative social equality in step with population trends such as urbanization. Following increasing inequality in the late 1970s, renewed government focus on improved access to basic services resulted in lowered inequality indicators (Collins and Park 1989b). In particular, Korea planned improved access to basic services in its 1982-1986 Five-Year Plan. The state focused on healthcare and education, mobilizing the private sector to spur on infrastructure construction especially in underserved rural areas (Republic of Korea 1982). The Asian crisis in 1997, when the poor were more adversely affected and unemployment rates skyrocketed, exposed weaknesses in the Korean social safety net and played a catalytic role in its subsequent maturity, in spite of upcoming challenges of sustainability (Lee, 2013). For both income inequality and inequality in access to resources, the origins of social inequality are highly dependent on each national context (Fields and Yoo 2000). However the Korean example offers lessons in processes of dealing with inequality, namely in a country's ability to make the proper diagnosis and to plan and implement policy. Among MICS, social protection effort should not be implemented on a piece-meal basis, but as part of a wider economic and social policy framework that is oriented towards inequality

reduction, which we can call ‘**social protection floor**’ (Ghosh 2013). The point is to universalize access to benefits in health, pensions, unemployment, child care and primary education, and make them individual rather than household based. This contributes more towards reducing poverty, containing inequality, sustaining equitable economic growth and encouraging greater empowerment and autonomy for women. A number of issues, including: public spending on health and education has a greater equalizing effect than direct transfers in all countries in the Latin American sample (Kingstone, 2013). Also, Inequality of access to services in MICs comes from the unequal expansion of service provision (Anderson et al. 2003). As state capabilities expand, access to services among high income groups increases. However, this does not necessarily mean that increased state capacity contributes automatically to increased overall access to services; political will to redistribute gains from growth is seen as just as important as growth itself in determining equality of access to services.<sup>14</sup> Inclusive growth policies in MICs are considered necessary to ensure more equal access to services and opportunities (Martens and McKinley 2011). Yet, while these ‘social protection floor’ policies have seen success in certain MICs, they are expensive and do not cover the entirety of the vulnerable population (UNDP 2011). Currently many countries - both rich and poor ones - are moving away from universal provision and recent moves towards fiscal austerity have made matters much worse (Ghosh 2013).

In order to address equality, one should take into account the specificities of the **labor** market among MICs. A vital concern in developing countries is employment diversification to enable the shift of workers to less fragile and better remunerated activities with safe and healthy working conditions (Ghosh 2013). For example, inequality particularly affects MICs whose economic progress stimulates a rise in life expectancy but is not accompanied by a rise in the number of workers in the formal sector (Ghai 2002). These countries are faced with two specific problems. First, there is the problem of providing social assistance to the very poor (faced by many other MICs and by all LICs as well). Secondly, they face the problem of a ‘missing middle’; the population that is not targeted by state welfare programs for the extreme poor, but does not benefit from the social insurance programs targeting formal sector workers with steady wages (Martens and McKinley 2011). Even in Latin America and the Caribbean, coverage is restricted to workers in formal employment around one half of the labour force, and In Asia and Africa, a very small minority of workers are in formal employment and social insurance is small scale (Barrientos 2013).

For Korea, social coverage in the 1960s was very selective and did not include workers at the margins of the labor market (Kwon 2001). In the process of expanding the social protection regime, the Korean government shifted in large part the burden of social welfare to private industry and to employers, which due to the unprecedented economic growth of the 1970s and 1980s proved sustainable for a time (Kim et al. 2011). The key policies outlining private provision of social protection services were initiated in the Fourth, Fifth and Sixth Five Year Plans for Economic and Social Development (Republic of Korea). These include medical, pension and unemployment insurance (Moon 1999). The policies began by placing burdens for social insurance on the shoulders of larger companies and the chaebol, before gradually including smaller enterprises (Woo-Cumings

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<sup>14</sup> This is a criticism of the Kuznets curve, which describes the relationship of gains in income per capita to inequality in growing economies as a positive one up to a point, before turning negative and resulting in an inverse-u-shaped curve. Criticisms of this theory on the relationship between income growth and inequality in development have pointed to the East Asian development experience as a series of cases which do not fit the Kuznets model. See Stiglitz 1996.

2004). For example, the medical insurance regime provided for mandatory implementation by companies of 500 or more workers in 1977, before expanding to include companies of 100 or more workers in 1984, and those of 16 or more workers in 1986, and of 5 or more in 1988 (Moon 1999). The strategy was one of a slow expansion of private provision, reflecting the rapid level of economic growth and increasing private sector capacity.

The public sector started taking on an increased portion of the social insurance burden in the early 1990s, notably with the Public Assistance Act of 1991 and the introduction of public pension schemes for civil servants and a minimum wage system. But it was with the 1997 financial crisis and increased public vulnerability that spurred increased expenditure on and state commitment to welfare policies (the government instituted a minimum living standard guarantee for the first time, largely to cope with the economic difficulties). The welfare regime expanded under the government of Kim Dae-Jung, starting in 1997, due largely in part to both high-level political will and popular consensus (Kwon 2002).

While the social pension and social protection regime was in large part subordinated to and directed by the dynamics of economic development during Korea's middle-income period, this experience holds significant implications for policy in MICs today. Firstly there is the importance of balancing and adjusting public and private sector roles. A lack of public capacity in service provision can, under certain conditions of partnership, be supported by some elements of the private sector. However in Korea these policies had the negative effect of perpetuating precariousness in the non-formal sector and among the self-employed, and loose monitoring and enforcement of policies resulted in the persistent exploitation of workers (most notably in the textile industry<sup>15</sup>) (Kim et al. 2011). This institutionalized exclusion is a key point to consider for MICs planning to expand coverage for low-skilled laborers in the manufacturing sector. Secondly, the Korean example underlines the importance of political will and social movements. The push for expanded insurance and welfare schemes came against the backdrop of the democratization movement of the late 1980s, and it was a combination of key policy actors and popular demand that brought about the post-financial crisis welfare reforms of the late 1990s (Kwon 2002). These factors give insight not only into actual policy options for MICs, but also into key background factors vital to navigating social protection policy.

Finally, the emergence of the so-called "**new middle classes**" earning from USD 2 to USD 10 a day deserves particular attention. Between 1990 and 2008, the growth in the shares of the population in this category among all developing countries was in the area of 30%. Yet, the term used to describe this group of people may be misleading, because whereas it emphasises the group's newly acquired economic prowess, it masks its extreme vulnerability. While they consume at a higher level, contribute to the sustainability of the economy and demand better social services and participation in decision making, they still remain destitute and, especially in the lower tier, they remain extremely vulnerable to shocks. This category should remain in the focus of policy makers, especially in terms of social policies (Kingstone, 2013).

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<sup>15</sup> See YeongRae Jo's Jeon Tae-Il Pyongjeon, Seoul: DolBaeGe. 2001.

## 2. Environmental inclusiveness

**Environmental concerns and Green Growth** present a particular challenge for MICs. This is because global development discourse is placing increasing importance on environmentally sustainable economic development.<sup>16</sup> Green growth should be understood as a broad and evolving concept built on “Sustainable Development” which comprehends more than environmental protection. It implies an economic restructuring which touches on the type and consumption of energy in a country, fostering economic growth and development while ensuring that natural assets continue to provide the resources and environmental services on which our well-being relies (Jeong 2013).

MICs are particularly affected by Green Growth concern when it comes to energy access, both in patterns of consumption and production. MICs concerned by this challenge are those with a high output in greenhouse gases and/or where growth has had a high negative impact on the environment, as well as countries where demand in energy is high or anticipated to grow quickly (Chandra et al. 2012). While energy use is still much lower than in high income countries, middle income countries are catching up quickly (Brosio 2013). Countries such as China, despite advances and investment towards green growth, are anticipated to continue to prioritize cheap and accessible energy sources, such as coal to satisfy growing energy needs (Chang and Gao 2011).

In addition, middle income countries include many important producers of oil, gas and minerals. These countries suffer from excessive use of energy both in consumption (through subsidization of fuels and electricity) and in production (energy intensive sectors) and they need to keep consumption down, at levels not distant from those of non-producing countries (Brosio 2013). Green Growth restructuring is not only expensive, but research suggests that investment in a green economy can be detrimental to productivity growth in the short-term (Issoufou and Ouattara 2011). However, some of the literature is however optimistic about the prospects of achieving the ‘triple win’ of social inclusiveness, environmentally friendly policies and economic development (World Bank 2012b). All countries need much new investment to adopt innovative technologies to help mitigate and adapt to the adverse consequences of climate change. Green Growth policies need to involve all levels of government, particularly in mega-cities (Brosio 2013). Policy making in that area should also give consideration to gender issues, as women are primarily affected by climate change, and most of the time absent from decision-making (Babugura 2013).

While Korea is currently at the forefront of current global discourse on Green Growth<sup>17</sup>, little emphasis was placed on environmental sustainability during the country’s period of concentrated urbanization and industrialization, from the 1960s to the 1980s (Kim 2011b). There were state efforts to control the impact of rapid economic development on the environment. In the late 1970s and early 1980s the state put together a basic environmental framework to both control fossil fuel emissions and promote more efficient energy technologies; the 1977 Environmental Conservation Act, the 1979 Rational Energy Utilization Act and the 1983 Emission Charge System are three central measures (UN DESA 1997). However these policies did not in all instances have the desired impact. The Emission Charge System, for example, put in place too low penalties for noncompliance with fuel emissions regulations. It also suffered from inadequate monitoring and corruption, rendering it

<sup>16</sup> Fakir, S. “The Green Growth Agenda: is this the New Hope?” Rio +20 Portal.

<<http://rio20.net/en/documentos/the-green-growth-agenda-is-this-the-new-hope>> <retrieved 28/05/2012>.

<sup>17</sup> “Korea’s Global Commitment to Green Growth” World Bank. Accessed 01/08/2012.

<<http://go.worldbank.org/NR18WLLIV0>>

ineffective at changing the rate of fuel emissions in the country (UNESCAP 2003). This means that there was minimal constraint placed on the private sector with regards to environmental sustainability, even after instituting the first pieces of legislation.

Also, while a more significant and restrictive legal framework for environmental sustainability was started toward the end of Korea's middle-income period, in the 1990s (Jang 1997; Kim 2011a; Republic of Korea, 2001), this time was also marked by widespread deregulations on use of semi-agricultural land which compounded the problem of urban sprawl and congestion (Moon 2006). It is significant to note that sustainable development policy focusing on the environment was largely nonexistent or ineffective during Korea's middle income period, and that the focus on social development emphasized from the 4<sup>th</sup> to 7<sup>th</sup> Five Year Economic and Social Development Plans was largely vacated of environmental policy agenda.

Over the recent years, with the advancement of its economy and increasing global attention on environment issues, Korea has tried to consider environmental and economic needs simultaneously by the adoption of environmental quality standards as well as incentive and monitoring instruments. The Lee Myung-bak administration also established a Green Growth and climate fund to assist countries in Southeast Asia (Lee, 2013).

We can tentatively conclude that lessons from the Korean development experience on environmental sustainability and green growth will be more significant if applied to upper-middle income countries. However, Green Growth preoccupation is not the preserve of upper-middle income countries and/or above, but relevant and crucial for all categories of countries from underdeveloped to developed countries (Jeong 2013). Therefore, Korea's current discourse can have potential benefit on the development of all categories of MICs. Additionally, given the relatively recent global development discourse on inclusive Green Growth, any understanding of Korea's MIC-period policies for present-day MICs must be referred back to current global goals and methodologies.

### 3. Inclusive financing

Socially and environmentally inclusive development requires particular means of financing. MICs are also impacted by challenges to **financing for development**. On official aid, MIC categorization has important consequences on the amount of development assistance received, as well as the more or less favorable conditions with which it is delivered —concessionality. Changes incurred in financing for development affect especially those MICs which rely more on ODA and loans to finance development. When a country reaches MIC status it incurs more expensive IBRD loans from the World Bank (World Bank 2007). Also, overall ODA flows to middle-income countries are slowly decreasing (ODI 2004b). However the graduation to middle-income country stage does not necessarily indicate a change in the need for aid. The MIC category contains a heterogeneous group of countries, and the literature is consistent in calling for diversified aid allocation methods, founded on more than income indicators (ODI 2004b; Glennie 2011; Sumner 2011). To address the growing development financing needs and to compensate for the progressive reduction of international assistance, MICs must identify new sources of financing both externally and domestically.

MICs have expedited reform to increase integration to the global financial markets. Reform minded Governments in MICs have gained more access to the much needed market development financing. As a result, investment, both private and public, has increased. While **FDI** flows tend to increase in countries advancing into upper MIC status, they remain low and poorly diversified in lower MICs. Those lower MICs that are rich in natural resources but have low capacity to innovate will attract FDI to the primary sectors for raw commodity and material exports, while those with less natural resources but endowed with ample supply of low cost labors will attract low cost manufacturing FDI, supplying both domestic and global markets. Lower MICs are also recipients of FDI tapping various project opportunities to develop the much needed public infrastructures. Therefore while upper middle income countries will need to focus on managing the pace of inflows and liberalization, lower middle income countries will need to implement a consistent macroeconomic policy framework, enhance the development of domestic capital markets, accumulate foreign exchange reserves as a form of self-insurance against shocks and strengthen the capacity of public institutions (Anglingkusmo 2013).

Due to Korea's particular geo-political importance at the start of the Cold War, it benefitted from grants and technical assistance from the United States. Korea entered its middle-income period in the later 1970s having managed to both successfully attract foreign capital and minimize foreign debt. It was these favorable conditions that allowed Korea to start minimizing its grants and leaning more towards foreign commercial loans to fund its development (Mason et al. 1980). Korea conserved a high savings rate throughout the 1980s, which along with a slowly deregulating financial market increased the possibilities for obtaining both foreign and domestic funds for development (Savada and Shaw 1990).

**Fiscal policies** must be explicitly under consideration, particularly tax policies, through their role in generating the resources needed for developmental policies. Notably, a focus should be given to tax policies that seek to improve collection from sectors and agents that have benefited disproportionately from aggregate income growth (Ghosh 2013). Special focus should be given to the informal sector, as informal workers do not contribute to formal systems of social insurance, such as pensions. Resource-rich countries also face a link between fiscal revenues and commodity

prices for commodity exporters and has highlighted in particular the risk to countries with public expenditures tied commodity-linked revenues rather than a broadened tax base (Kingstone, 2013). Efficient policies of public spending do not necessarily require higher tax rates - better and more effective implementation of existing tax laws and closing tax loopholes can be even more effective. They are not only affordable for MICs but can - in the long run - pay for themselves, by enhancing the productiveness of the labour force, the resilience of society and the stability of the polity (Ghosh 2013). Notably, wide-based energy or environmental taxes can should be explored by MICs as a way for development financing. A multi-package environmental tax system can (1) mitigate the pollution problem by reducing energy use (2) allow the government to reduce distortionary taxes, such as wage taxes, which would raise the net wage, and hence raise labour supply and (3) contribute to shift from informal to formal sector through cuts in taxes on wages, hence enhancing the overall rate of growth of the economy (Brosio 2013).

Korea was able to successfully finance development by modernizing its tax system. The 1966 establishment of the National Tax Service instituted reform in tax-related data collection, tax administration as well as contributed to minimizing corruption and creating social consensus for compliance among taxpayers (Kim and Kim, 2012). As a result the state was able to increase government savings<sup>18</sup> and more easily induce capital inflows, which in turn contributed to higher public and private investment (Ibid). One other relevant point is Korea's use of earmarked taxes, especially for transportation. Korea successfully expanded its transport facilities through income from a tax on gasoline and diesel fuels. However the ultimate success of this scheme is still debated (KDI 2010). The merits and demerits of earmarked taxes for targeted development projects can be analyzed in more detail through the Korean experience.<sup>19</sup> In conclusion, while Korea's initial low-debt status and access to American grants presents a unique case, its successful macroeconomic strategy and key reforms to raise the necessary funds for development are significant to countries about to graduate to MIC status and which anticipate increased difficulty in obtaining development loans.

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<sup>18</sup> Tax revenues doubled to average 17% of GNP by 1975. (Kim and Kim 2012)

<sup>19</sup> The KDI Modularization Report on taxation policy accomplishes just that; it looks at the pros and cons of Korean tax policy in detail with as goal to give advice to developing countries considering implementing similar policies.

## V. Cross cutting issues

Finally, certain cross-cutting issues affect middle-income countries in unique ways, impacting both purely growth-related as well as equity-related issues. Properly examining these challenges in light of the Korean experience thus requires a comprehensive understanding of Korean industrial, growth and social policy.

Challenges related to **population** impact both growth and social services, in several ways. On one hand many MICs must manage young, growing and increasingly urban populations (Asian Development Bank 2011). Others, most notably China, are facing a population crunch which combined with an aging population could adversely impact a growing economy.<sup>20</sup> Two sets of challenges emerge from both of these trends. The first is a challenge to education and productivity. Countries like Nigeria stand to benefit from their growing population, but only if policies focus on both incorporating youth into formal economic activity and adapting education policy to ensure that a growing population translates into growing output (Dauda 2010). Similarly MICs with high rates of urbanization like Gabon must provide policy responses to successfully absorb the urban population into urban economic activity, or find alternative ways to promote activities outside of the capital or urban zones. The second is a challenge to service provision and social equality, including gender inequality (Babugura 2013). The Nigerian example shows that if economic output does not keep the pace with population growth, per-capita consumption of social services stays low (Onwuka 2006).

As part of this demographic challenge, urbanization deserves particular attention. Urbanization matters for growth, as geographic aspects of the demographic transformation have to be more distinctively shed light on, as the demographic transition coincides with a spatial transformation (Jeong 2013). However, an increase in the size of the urban population has not necessarily been associated with growth, especially in Africa urbanization, accompanied by very low growth, is concentrating poor people in cities rather than the countryside .

Korea's own middle-income experience is marked by a sharply curbing population growth and by high rates of **urbanization** (Kim 1994). A very successful<sup>21</sup> state fertility control campaign brought down the population growth rate from its postwar high of 3% in 1960 to just 1.7% in 1975 (Kim Et. al. 1996). However the rate of urbanization over this same period jumped sharply, from close to 20% in 1960 to nearly 50% in 1975, showing no signs of slowing (Kang 1998). In the 1970s, rural zones in Korea were recording 3% population losses per year (cite Ibid). State population policy during the 1970s attempted to ease the urban concentration while simultaneously promoting social welfare access and education.

The Korean government started launching corrective policies aimed at reducing the urbanization rate and improving access to social services (Ibid). On one hand the government increased loans and subsidies to the agricultural sector throughout the 1970s (Dornbusch and Park 1987). Also, the state helped to establish and populate satellite cities around the Seoul metropolitan area, attracting

<sup>20</sup> Zhou, S. "China's Reverse Population Bomb." Asia Times. 06/11/2006.

<<http://www.atimes.com/atimes/China/HK01Ad01.html>> <retrieved 03/05/2012>.

<sup>21</sup> Perhaps too successful; Korea is projected to have the oldest population in the OECD by 2050. See <<http://www.oecd.org/eco/economicsurveyofkorea2012.htm>> Accessed 29/07/2012.

manufacturing businesses moving out of the capital as well as diverting the inflow of new businesses and people (Rii and Park, 2001). Businesses were given various tax incentives to relocate, while the state stressed the high quality of education facilities in the new locations to attract more families (Lett, 1998). The state used shifting industrial structures to promote decentralization: starting in the 1970s the economy moved away from its focus on labor intensive exports and towards heavy and chemical industries. This structure was favorable to the decentralization of industry, and the state created incentives to move new industries away from the capital region, toward the southeast of the country. The state directed investment in these industries (usually located in port cities such as Ulsan) and fashioned vocational education institutions around them (Kim 1988). This was partially successful in creating rival regional centers of economic activity to Seoul, the capital.

However these policies are not deemed to have been successful wither in stemming the rate of urbanization, concentration in the capital city, or the access of citizens to social services. On one hand satellite cities were built up in close proximity to Seoul, creating an additional crowding effect (Rii and Park, 2001). Also, agricultural 'rebalancing policies' proved unsustainable as the state scaled down most of its agricultural subsidies at the beginning of the 1980s. Finally the reach of social protection is not considered to have benefitted from population policies as low coverage and pockets of exclusion still appeared in urban areas. Rather, the expansion of social welfare during the 1970s and 1980s is attributed more to expanding economic growth (Kim 1988). The Korean example underlines the importance for middle-income countries to couple analysis of population policy and economic structure as they relate to education, social policies and to the movement of populations.

## VI. Conclusion

A number of useful conclusions may be drawn from this desk review pertaining to MIC development policy and to sharing knowledge from Korea's development experience.

First, our 'mapping' research has led to a list of basic common challenges faced by MICs and applicable insight from the Korean development experience, ranging across six main categories. First, there are challenges to economic and financial stability brought on by global and regional financial flows as well as the extent of openness of a country's markets and trade regimes. The Korean case showcases specific macroeconomic mechanisms and tools used to avoid crises, but also gives insight into how Korea recovered after it had experienced crises during its middle-income period. Next are challenges to economic growth, in which the planning and implementing role of both state and private actors is a key point. Korea's success in navigating the relationship between state and non-state and between plan and implementation greatly informs its successes in overcoming challenges to growth. Also, challenges to social equity take on certain particular dimensions in MICs, and this review has seen how Korea's answers to problems of income inequality and access to social services have shaped its social welfare regime of today. Environmental challenges may be the key to understanding and managing sustainable future growth for MICs, for which Korea offers mixed lessons but interesting prospects. Both environmental and social inclusiveness have to come with appropriate ways of financing; importance should be given to Korea's taxation system but also to more recent innovative strategies. Finally, all these challenges should comprehend the crucial role of demography, particularly concentration into urban areas.

Secondly, looking at the Korean experience provides insight not only into problems MICs are currently facing, but also into challenges not yet encountered. Looking at the appropriate socio-economic indicators in Korea when it came to face a particular developmental challenge indicates a possible trend –MICs in a similar situation may face the same challenges. This can be useful in determining the timeframe in which MICs should adopt certain policies. It is important to stress that the Korean experience is relevant for its successes but also for its setbacks. Examining the peripeteia of Korean development policies gives insight into the policy making process as well as to the variety of policy options available to respond to a given challenge. Examining policy for development is not a simple two-step matter of identifying the 'correct' policies from different countries and adapting them to another context. More consideration must be given to the policy formulation process (the 'how') and to a thorough understanding of the direction a given country is taking for its development (the 'why').

Lastly, we have underlined the diversity of MICs, which underscores the need to understand them in smaller groupings in order to come to more specific policy conclusions. Some important factors that differentiate MICs are share of employment in low/high productivity activities and low/high value added exports, inequality, degree of governance, institutional capability, as well as size and resource endowment. Any future reevaluation of the MIC category should be grounded in realities of global development. It is the combination of an approach overviewing the common challenges shared by all MICs and a more detailed analysis of how similar problems manifest themselves in a particular or small grouping of MICs that may lead to effective policy action.

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*[Cover photo: 1978. Urbanization in progress in GangNam's Apgujeong-dong. Jeon Min Jo Portfolio 'Seoul 1969-1990']*



Experts Meeting

# COMMON CHALLENGES OF THE MIDDLE-INCOME COUNTRIES

13-15 May 2013, Seoul, Republic of Korea



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Common Challenges, Multiple Perspectives:  
**Middle Income Countries Experts' Consultation**  
**First Session, 13-15 May 2013**  
Holiday Inn, Seongbuk, Seoul, Republic of Korea

## Concept Note

### 1. Background

In 2012, UNDP-SPC prepared a desk review providing an overview of key, common MIC challenges, along with a concept note outlining the planned experts' and policy consultation on the key identified challenges expected to take place over the period 2013-2014. Both documents organize MIC challenges to development in provisional thematic groupings for further policy and research engagement.

The World Bank currently classifies 103 countries as middle-income. This diverse and growing group still exhibits serious challenges to development. With some of the world's most populous countries (India, Indonesia, Nigeria etc.) having recently joined this category, a majority of the world's poor now live in middle-income countries (MICs). This shift in the global balance of poverty prevalence requires new and different ways of approaching the developmental challenges in MICs.

Middle-income countries include many fast-growing and high-performing economies. These countries are ever more empowered to present and share their own development solutions, as MICs are becoming more active in their role as holders of valuable development knowledge. This trend was confirmed notably at the 2011 Busan HLF-4, which stressed the importance of South-South and trilateral cooperation, emphasizing the central role of new developmental actors including emerging donor states in creating, sharing and applying knowledge in development. Middle-income countries in particular, facing common challenges to development, stand to greatly benefit from this new focus. Insightful knowledge sharing and policy advice from both countries which have overcome key development challenges and from other MICs currently dealing with similar issues could help to formulate innovative and practical policy solutions.

MICs, while a diverse group, experience a number of key common challenges to development, shared across borders. As such identifying these common challenges and engaging in a dialogue to share how some countries have already addressed or are addressing these challenges and to jointly explore new policy and implementation options, can be beneficial for all participants in this dialogue. MICs include many fast-growing economies and a myriad of development experiences, which are being progressively more promoted as valuable knowledge. As both providers and consumers of new development knowledge, MICs stand to greatly benefit from this new focus. Insightful knowledge sharing and policy advice from both countries which have overcome key

development challenges and from other MICs currently dealing with similar issues could help to formulate innovative and practical policy solutions.

## 2. Objectives

### 2.1. Objective of Policy Consultations

The **UNDP Seoul Policy Centre** (UNDP-SPC), the Korean **Ministry of Foreign Affairs** (MOFA) and the **Korea Institute for International Economic Policy** (KIEP) are jointly organizing a series of experts' consultations to advance the debate on development policy for middle-income countries (MICs). It will be exploring in depth key common development challenges MICs are facing, as well as potential options to address them, and looking at central policies and practices from MIC experiences which could be applied across national borders. These consultations will bring together leading MIC scholars, development practitioners and policy makers both from middle income countries and development partners to discuss the key challenges to development MICs are facing and to identify and share policy solutions to respond to these challenges. South Korea's rapid transformation has been attracting a lot of attention and will be a central reference for discussion

The policy consultations are expected to have an impact on the global policy dialogue surrounding MICs, by promoting a broader conceptual understanding, and by helping structure the key common development issues debate. This series of policy consultations will also contribute to the growing South-South dialogue and exchange of knowledge among MICs.

### 2.2. Objective of the first Expert Session

This first Expert Session is the first step of the planned series of policy consultations. It will bring together top international development experts in order to address the following:

- To **validate the 'mapping'** and organization of central challenges facing MICs conducted by UNDP-SPC and presented in the Desk Review, by contrasting existing and ongoing Centre research into MICs with experts' own insights. Additional key themes or sub-themes which require further investigation, research and policy discussion may be identified. As part of the process, the Session will address the notion of MIC category, and its current use in the development policies and practices.
- To assist in **prioritizing the order** in which the MIC challenges will be addressed through the policy dialogue and refining the approach for these policy consultations. This will be achieved by examining the most serious and pressing shared challenges MICs are facing. Also, this will be done by examining the interconnectedness of the development challenges.
- To conceptualize how **relevant development knowledge** from MICs can be best captured, shared and employed across countries. This includes examining existing practices in knowledge transfer and knowledge sharing among middle-income countries, looking at how to further harness them to facilitate South-South transfer of knowledge.

**Future in-depth research and policy engagement** may emerge based on the findings and output of the first Expert Session.

The experts would be invited to continue serving as an advisory panel for the roll out of the policy consultations and to be leading resource persons in these policy consultations.

### 3. Agenda

#### 3.1. Topics

The conceptual work done so far on the issue of Middle Income Countries has identified four key common challenges to MICs, arranged under thematic groupings and sub-groupings:

- |  |   |
|--|---|
| <p><b>I. Inequality, Welfare and Social Policy</b></p> <ul style="list-style-type: none"><li>- Geographical inequality</li><li>- Sector inequality</li><li>- Social inequality and vulnerability</li><li>- Inequality and access to basic resources and services</li><li>- Inequality and access to education and labor market</li></ul> | <p><b>II. Inclusive Growth and Competitiveness</b></p> <ul style="list-style-type: none"><li>- Competitiveness and increase in the value chain</li><li>- Economic coordination</li><li>- Research and Development</li><li>- Domestic market vs. exports</li><li>- Self-sufficiency vs. foreign dependency</li></ul> |
| <p><b>III. Economic and Financial Crises</b></p> <ul style="list-style-type: none"><li>- Financial foundation of MICs</li><li>- Commodity market dependency</li><li>- MICs and the global financial crisis</li></ul>   | <p><b>IV. Climate Change and Green Growth</b></p> <ul style="list-style-type: none"><li>- Impact of climate change</li><li>- MICs and sustainable development</li><li>- Green growth and lesson-learnt from developed countries</li></ul>   |

#### 3.2. Discussion structure

The Session is expected to take place over a period of two and a half days.

The **initial morning** will focus on the general review of the Desk Research Paper.

Three selected participants will make a short presentation on their views of MICs. The ensuing discussions will:

- Comment upon the broad trends in the MIC category and its current use in the development policies and practices;
- review the key assumptions and categorizations of the Desk Research Paper;
- validate the choice of challenges and identify potential missing challenges;
- identify the most vital and/or pressing challenges facing MICs;
- explore the interconnectedness of certain development challenges and on how they can be addressed by policy;
- reflect on the strategies by MICS and development partners, bilateral and multilateral, in response to these challenges and their effectiveness .

**Subsequent meetings** will review more in depth each one of the identified key common development challenges for MICs mentioned in 3.1.

The objective will be to further validate, prioritize and look at the interconnectedness of the component of each key challenge. It will also be the opportunity to introduce, if need be, potentially missing challenges.

There will be a discussion session based on the initial presentations for each thematic group. Subsequent to the presentations, all of the attendees will participate in an open-ended discussion.

A **synthesis discussion** will complete the thematic groupings review by looking at the interconnectedness among all the key themes and agreeing on the sequencing of the policy consultations that will educate the action plan.

Participants will agree on the enhancement needed for the desk review document and on the best approach for the roll-out of the policy consultations, including the way in which relevant development knowledge from MICs can be best captured, harnessed and shared.

Common Challenges, Multiple Perspectives:  
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**Participants**

**I. Introduction**

Jonathan Glennie

Eva A. Paus

Kye-Woo Lee

**II. Inequality, Welfare and Social Policy**

Armando Barrientos

Jayati Ghosh

Peter Kingstone

**III. Inclusive Growth and Competitiveness**

Adeola Adenikinju

Kenichi Ohno

Ajit Singh

**IV. Economic and Financial Crises**

Reza Anglingkusumo

Giorgio Brosio

Deok Ryong Yoon

**V. Climate Change and Green Growth**

Agnes Ariho Babugura

Okju Jeong

## Introduction



### Jonathan Glennie

Jonathan Glennie is an independent writer and consultant, a Research Associate (formerly Senior Research Fellow) with the Overseas Development Institute, and a Guardian columnist. Previously, he managed Christian Aid's aid programme in Colombia and worked on several international campaigns, including Make Poverty History and the Jubilee Debt Campaign. He is the author of *The Trouble with Aid: Why less could mean more for Africa* (Zed Books, 2008).

He analyses current evidence, thinking and practice on international support to Middle Income Countries (MICs) in his paper on "The role of aid to middle-income countries: a contribution to evolving EU development policy."

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Paus has published widely on development strategies and globalization. She is the editor of the forthcoming book *Getting Development Right: Structural Transformation, Inclusion and Sustainability in the Post-Crisis Era* (Palgrave Macmillan, 2013). In this book, prominent scholars and practitioners analyze the challenges highlighted in the title and identify important policy areas where we can address the challenges together rather than piecemeal. During 2010-2012 Paus led a project on the middle income trap. The international research team developed an analytical framework that focuses on the development of productive capabilities, and they used it to analyze the upgrading experience of five small latecomers operating under a liberal trade and investment regime. The results were published in a special issue in *Studies in Comparative International Development* (July 2012).

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Prof. Kye Woo LEE is currently a visiting professor of economics at the Korea Development Institute School of Public Policy and Management in Seoul, Republic of Korea. He served as a Chair Professor of Economics of Graduate School of International Studies, Hankuk University of Foreign Studies and taught also at the Graduate School of International Studies of the Seoul National University and Ewha University in Seoul.

He was a member of Prime Minister's Committee on International Development Cooperation and served as an advisor to the Korea Chamber of Commerce and Industry, and the Korea Export and Import Bank, which offers official development assistance to developing countries. He received an Award of Appreciation from the Minister of Foreign Affairs and Trade for his advisory role.

Until Prof. Lee repatriated to Korea, he had served with the World Bank in Washington, DC in various capacities including executive and economist positions for almost 30 years. He was also President of the Korea Economic Society in the United States. Before joining the World Bank, he was a middle-level manager with the government of Korea, after topping at the Government Examination for Ranking Officials. While serving with the World Bank, Prof. Lee received the Presidential Award for Excellence in Projects Outcomes and was seconded by the World Bank and UNDP as advisor to the Economic Planning Board of the Government of Korea for the Fifth Five-Year Economic Plan preparation.

Prof. Lee has written several books and numerous professional and academic articles in domestic and international journals on international trade and finance, economic development, human development, poverty and income distribution, social safety nets, international organizations, and Latin American economies.

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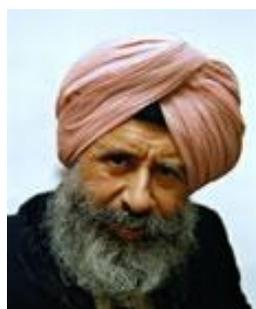


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His books include *Dollar and Yen* (with Ronald McKinnon, 1997), *East Asian Development Economics* (Japanese, with Kojiro Sakurai, 1997), *Japanese Views on Economic Development* (co-edited with Izumi Ohno, 1998), *The Economic Development of Japan: The Path Traveled by Japan as a Developing Country* (2006), *The Middle Income Trap: Implications for Industrialization Strategies in East Asia and Africa* (2009), and *Meiji Restoration 1858-1881* (Japanese, with Junji Banno, 2010). He holds a Ph.D. in Economics from Stanford University.

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## I. Introduction: MICs, the middle-income trap and Korea

### 1. Globalization and the Middle Income Trap: a Capabilities-Based Approach with a Focus on Latin America

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#### Growth appearances are deceiving

Middle income countries seem to have done rather well during the 2000s. They reversed the long trend of income divergence with high-income countries, and they recovered much better from the global crisis than Japan, the US, and the EU. But appearances are deceiving. Not all growth is created equal. Theory and experience suggests that growth in latecomers can only be sustained if it is based on productivity growth and a positive transformation of the production structure.

Over the last 20–30 years, many middle income countries, particularly in Latin America, have seen productivity-reducing structural change, where labor has moved to activities with lower, not higher, productivity (McMillan and Rodrik 2011, Ocampo, Rada, Taylor 2009). Productivity-reducing structural change reflects the expansion of low-paid jobs and growing informality, as opposed to productivity-enhancing structural change which generates the possibility for increased living standards through more decent jobs.

#### Changing the focus: from growth to productive capability advancement

The driving force behind sustained productivity growth is the accumulation of technological capabilities that allows for broad-based structural change towards higher value added activities. To explain technological capabilities outcomes and their changes over time, we need to shift the focus from economic growth to its underlying basis. A useful framework for analysis is the capabilities-based approach which draws on structuralist and evolutionary economic thought and global value chain analysis. It emphasizes learning and analyzes the accumulation and interaction of social and firm level capabilities in the context of specific national and global characteristics (Paus 2012).

We can distinguish different stages in the process of technological capability accumulation, each requiring different expressions of social capabilities to support advances in firm level capabilities at that level (Paus 2012, Ohno 2010, Lee 2009). Successful middle income countries tend to exhibit three main traits: (1) a significant percentage of local firms has learned to adapt technological knowledge from more advanced countries to the firm and country-specific context through licensing and capital goods imports, and some local firms have developed sufficient capabilities to absorb technology spillovers from the production of TNC affiliates in the country; (2) outside of resource extraction, TNC affiliates have started to move away from the assembly of labor intensive, low-tech goods towards production in medium and high-tech goods, though that may still be

concentrated at the assembly stage. And (3), skills training programs and growing/high enrolments at the secondary school level are the key social capabilities in education.

Moving to the next phase of capability accumulation requires the development of a national innovation system, with increasing enrolments at the tertiary level, more specialized technical skills, greater public expenditures on R&D, and greater sophistication of the ICT infrastructure. The advancement of these social capabilities enables growing research and development activities by local firms (eventually towards more design) and a movement of TNC affiliates towards higher value added activities and some R&D. When social and firm-level capabilities advance together and surpass a critical threshold, knowledge-intensive activities become a growing share of the productive sector.

Due to the pervasiveness of coordination failures and market inadequacies as well as the need for non-marginal changes, pro-active government policies are needed for the move to a knowledge-based economy, including the appropriate incentive structure for learning in these new activities. The demands on government activism for moving beyond the middle income level are contrary to the credo and practice of the Washington Consensus.

When Latin American governments started to embrace the liberal market policies of the Washington Consensus in the 1980s, the focus was on macro stabilization and allocative efficiencies, with little attention to promoting technological capability accumulation. The result was pre-mature de-industrialization, with the share of manufacturing value added in GDP declining from 27 % in 1980 to 17.1% in 2010. That is roughly the same level as high-income OECD countries (15.8 %) and substantially below developing East Asia and Pacific (28.8%) [WDI]. Not surprisingly, innovation efforts stayed low under Washington Consensus policies. With the exception of Brazil, the R&D ratio in most Latin American countries has remained at around 0.3 % of GDP, considerably lower than in the Asian middle income countries.

### **The threat of a Middle Income Trap (MIT)**

Middle income countries have always faced the challenge of how to move from commodity production to more knowledge-intensive activities. But it is only in the last few years that the term 'middle income trap' has emerged. This is no coincidence. In contrast to authors who call attention to the middle income trap on account of a slowdown in growth and internal factors only (e.g. Eichengreen, Park and Shin 2011, Asian Development Bank 2011), I submit that the "trap" captures the realities of internal as well as external factors at this juncture in the globalization process.

Over the last 20 years, global competition has intensified dramatically, the speed of technological change has increased, product cycles have come shorter, and China has become a fierce competitor in low-tech and high-tech goods. As a result middle income countries find themselves increasingly unable to compete with low-wage countries in the production of labor-intensive commodities, but they have not developed the capabilities to compete on a broad basis in higher productivity activities (Kuroda 2011, NEAC 2010, Paus 2012, 2009, World Bank 2010, Yusuf and Nabeshima 2009, Abugattas and Paus 2008).

Situating our understanding of the middle income trap in the current globalization context has two main implications. First, it suggests that middle income countries have less time for achieving

broad-based upgrading towards more knowledge-intensive goods and activities. And second, it highlights that the nature of the rise of China has increased the urgency to pursue broad-based upgrading. A growing literature shows that Latin American countries are losing out against China in third markets in the North, in regional markets and in home markets (Gallager and Porzecansky 2011, Jenkins, forthcoming).

### **From Learning by Trading to Learning by Doing: Challenges for Latin American Countries**

Under neoliberalism, policies for the productive sector were primarily horizontal and aimed at correcting market failures and at making markets work better. The pursuit of free trade and investment agreements, on a bilateral and multilateral level, enshrined open markets and limited policy space. When it became clear in the 2000s that technological capabilities in Latin America were insufficient to allow producers to compete successfully in the new global environment, productivist policies re-emerged in a number of countries..

Based on the literature, we can identify 10 challenges to the successful implementation and outcomes of new productivist policies aimed at accelerating the development of higher value added and knowledge-intensive activities:

- (1) Currently policies are often piece-meal and not part of an overall strategic focus on the advancement of technological capabilities, a strategy that has to be cognizant of the highly dualistic production sector (Paus 2011)
- (2) Policies are often not well coordinated across government institutions; public-private collaborations (e.g. the many National Competitiveness Councils) often do not carry sufficient political weight; and strategies do not surpass the short-termism of election cycle (Devlin and Moguillansky 2012).
- (3) Productivist policies tend to lack transparency and accountability (Almeida and Schneider 2012 on Brazil), and their effectiveness is rarely evaluated (Peres 2011).
- (4) Fiscal resources are inadequate in most countries, with tax ratios considerably below what would be expected at the countries' GDP p.c. level (Abugattas and Paus 2009, Agosin, Larraín and Grau 2009).
- (5) Most countries do not have a merit-based professional and technically capable civil service. Devlin and Moguillansky (2012) call it the Achilles heel of industrial policy in Latin America.
- (6) Macro policies, particularly overvalued exchange rates, frequently mitigate against learning and capability accumulation (Cimoli, Porcile, Calza, 2013).
- (7) Incentive structure provides weak economic signals for local firms (Peres 2011).
- (8) Governments have neglected the strategic role that TNC affiliates can play in the development of technological capabilities and upgrading.
- (9) It is not clear that there is sufficient political will to pursue a capability-based strategy. Who are stakeholders?

(10) More deliberate attention has to be paid to devising a more integrative policy response to the challenges of structural transformation, inclusion, and environmental sustainability (Paus, 2013).

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## 2. Challenges of middle income countries: the case study of Korea

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I feel privileged to address this experts meeting on development policies for middle income countries. I want to express my sincere appreciation to the UNDP/SPC in Seoul and KIEP.

My assignment is to discuss Korea, which between 1960 and 1990 achieved economic growth worthy of being called a miracle (Lucas Jr. 1993, Making a Miracle). Specifically, I am to discuss Korea's development processes in terms of challenges facing middle income countries (MICs). This is a tall order to carry out in 15 minutes, but I hope to accomplish my own "miracle of economy" and highlight features relevant to growth, crisis management, social policies, and climate change.

### Economic Growth

Korea's average annual growth rate was 10.3% during the 1970s and 9.8% during the 1980s, doubling national income every 7 years. The country has performed as an OECD member since 1996, sharing its income with other developing countries as the first nation that transitioned from an aid recipient to a DAC member aid donor. Today, it aspires to become a welfare state on the basis of sound market and democratic systems.

Korea's transformation reflects government's evolving role, spurred sometimes by design and sometimes in response to challenges. The rapid growth of the 1960s and 1970s was driven by government-led industrialization and export expansion. The share of the industrial sector (manufacturing, construction and public utilities) in the total value-added more than doubled from 17% in the 1950s to 38% in the 1980s. By contrast, the share of the primary sector fell from 42% to 3% in the same period. In addition, total trading volume rose from about 10% of GDP in the 1950s to over 90% in recent years. Cross-border capital movement also increased rapidly during the same period.

From 1962, the autocratic government sought to jump-start the economy by formulating a series of Five-Year Economic Development Plans. In the 1960s, the government actively promoted exports of labor-intensive light industry goods of all sectors with generous fiscal and financial incentives. These industries absorbed surplus labor from rural areas and helped increase per-capita income and savings rates of both urban and rural populations.

In the 1970s, the government shifted to promoting heavy and chemical industries (HCIs) and their exports. It selectively supported firms with radical fiscal and financial incentives, external loans and investment, skilled-technical human resources, R&D, and heavy infrastructure investment, including industrial export parks, ports, dams, and highways. To allocate resources in favor of the HCIs, the government strengthened its control over financial institutions, including the central bank, and labor unions.

In pursuit of fast economic growth, the government paid inadequate attention to elements of modernization and sustainable development: macro-stability, fair competition, financial development, import liberalization, labor market reform, and environmental protection, let alone

income equality. However, it selected some development strategies that were also conducive to equity and balanced regional growth, such as a human development strategy that emphasized basic and middle-level education, and the Saemaeul program (a rural development movement).

### **Stabilization and Liberalization (Competition)**

The government led growth strategy, such as the HCI drive, concentration of economic power in business conglomerates (chaebols), and the suppression of sound labor movements, had produced many side effects, including serious resource misallocations, chronic inflation, and greater income inequality. In the 1980s, in view of changing domestic and international circumstances, the government shifted its role to promoting economic stabilization, liberalization and social policies.

Stabilization was pursued initially with monetary contractions, but lacked effectiveness, mainly due to the persistence of the directed credit system. Price stabilization was achieved mainly through fiscal consolidation and investment coordination. The rice price paid by the government to farmers was set far below the level demanded, and a zero-based budgeting system was introduced. By 1985, inflation was brought below 10%, where it remained ever since, and by 1987, fiscal balance was restored. Investment coordination, begun in 1979 to address the overcapacity and worsening profitability of HCIs, covered many other industries as well, and continued throughout the 1980s. Such coordination and industrial rationalization were achieved through mergers and restrictions on entry and investment in rationalized industries. Tax benefits and financial supports (debt rescheduling and reduction, and new lending) for the rationalized firms aimed to reduce the risk of economic crisis.

Economic liberalization involved financial and trade changes. In 1992 the stock market was opened to foreigners. Another round of economic liberalization came after 1993, when a civilian government came to power after two decades of repressive rule. Many banks and non-bank financial institutions (NBFIs) were allowed to enter the market, banks were allowed to manage trust accounts, and the interest rate on commercial papers (CPs), which were the main target of investment by the trust accounts, was liberalized. However, directed credits continued, especially for small and medium enterprises (SMEs) and agricultural, fisheries, and livestock cooperatives as part of debt relief. In addition, the large amount of corporate debt precluded greater interest rate liberalization.

Trade liberalization was pursued not so much to improve consumer welfare, as to enhance the international competitiveness of domestic industries and to diversify imports. Therefore, agriculture was heavily protected. Import liberalization gathered speed as the current account turned to a surplus in 1986 for the first time. Tariffs declined from 34.4% to 9.8% between 1981 and 1995, while import liberalization from quantitative restrictions rose from 61% to 92%.

Capital market liberalization significantly lagged trade liberalization mainly due to concern about control over the domestic money supply and the real exchange rate movement. Although efforts were made to liberalize capital inflows from 1993, capital market liberalization before the 1997 Asian crisis was centered on banks and non-bank financial institutions (NBFIs) for short-term foreign currency borrowing. In the mid-1990s, the government substantially reduced regulations on overseas activities of banks and NBFIs and on their required share of long-term liability in their debt portfolios, encouraging short-term borrowing from abroad.

Economic liberalization included competition policies. In 1981, the Monopoly Regulation and Fair Trade Act (MRFTA) became effective, and the Fair Trade Commission was instituted. Gradually the MRFTA incorporated regulations on chaebols: the cross-shareholding regulation and basket control of credit. These regulations were followed by ad-hoc regulations on cross-debt guarantees, intra-group transactions, business diversification, and ownership structure. The competition policy also included privatization of state owned enterprises (SOEs). In 1993, the government announced a plan to sell all government shares in 58 out of 133 SOEs.

However, economic stabilization was achieved with serious costs in terms of lost outputs and increased unemployment, which jumped from 3.8% in 1979 to 5.2% in 1980, and then stayed at 4.0-4.5% before falling to 2.5% in 1988. Investment coordination also helped concentrate economic power in chaebols and postponed genuine corporate restructuring, increasing moral hazards, strengthening risk partnership between public and private sectors, and discouraging private sector-led growth.

Moreover, the economic liberalization policies were only half-successful in redefining the roles of government and the private sector. Despite privatization of commercial banks, government intervention continued in management appointments, asset management, and organizational changes. Instability of the financial system increased with financial liberalization as regulation was not strengthened simultaneously. A vast array of regulations on chaebols failed to stop the concentration of economic power. The share of the largest 100 companies in mining and manufacturing remained at 40-45% of total shipments and 20% of employment. Free and fair competition policies were interpreted as deregulation, which in turn focused on freeing businesses from red tape and thereby stimulating investment. New and better regulation did not receive much attention.

Implementation of the ground-breaking privatization plan also fell far short of the original intent. Solutions for stabilization and economic liberalization had to await the advent of the Asian crisis in 1997.

Thus, ironically, when Lucas talked in 1993 about Korea "Making a Miracle," the Korean economy was already undergoing a growth rate decline from 8.1% during 1990-95 to 3.6% during 2004-09. Thus, the potential growth rate declined by about 5 percentage points. The decline was accompanied by stagnant employment growth and was explained mostly by a decline in investment, i.e., capital and labor inputs, as total factor productivity growth rose from 0.8% per year during 1990-95 to 2% per year during 2000-05, slightly above the 1.5% per year during 1960-90. The key to solving this problem of declining growth rates seems to lie in improving the productivity of the two lagging sectors, i.e., the service sector and the SMEs.

### **Economic and Financial Crises**

Korea's first economic crisis began in November 1997, as foreign creditors rushed to withdraw their loans to domestic banks and NBFIs. Korea's foreign exchange reserve was quickly depleted, and an explosive devaluation followed. The most representative theories explaining the crisis are the weak

economic fundamentals of the country and the self-fulfilling nature of the crisis. The Korean government took the position that both theories contained some degree of truth. Therefore, it focused on (i) restructuring corporate and financial sectors to redress their fundamental weaknesses, and (ii) seeking international help in overcoming illiquidity. In addition, the government carried out the labor market reform and public sector reform as well.

Initially, the government tightened monetary and fiscal policies to contract domestic demand, improve the current account balance, and stabilize the exchange rate. Once the liquidity crisis subsided, the government switched to an expansionary mode. The interest rate was lowered, exports expanded, and output growth recovered rapidly from -5.7% in 1997 to 10.7% in 1998. Then, the government embarked on a thorough reform of the corporate, financial and public sectors, and the labor market.

The corporate sector reform had two objectives: restructuring insolvent firms and strengthening market discipline to prevent future crises. Two strategies addressed the restructuring objective. One was the swapping of business between chaebols, arranged and enforced by the government. The other was out-of-court settlements, known as “workout” programs, to speed up restructuring.

To strengthen market disciplines, “the five plus three principles” were adopted. They are (i) enhancing the transparency of corporate management (mandatory consolidated financial statements, international accounting standards, appointment of outside directors), (ii) eliminating cross-debt guarantees (a uniform debt-equity ratio ceiling of 200%), (iii) improving the capital structure, (iv) focusing on core lines of business and strengthening cooperation with SMEs, and (v) increasing the accountability of controlling shareholders and managers. The “plus three” principles were added later: (i) improving the governance structure of NBFIs to avoid chaebols’ exploitation, (ii) restraining intra-group circular shareholdings within the chaebol and blocking insider trading, and (iii) prohibiting unlawful inheritance and gifts. Additional efforts were made to (i) dispel moral hazard (by introducing a partial deposit insurance system and forward-looking criteria for non-performing loans, allowing insolvent firms to go bankrupt), (ii) improve corporate governance (by relaxing conditions on shareholders’ rights, expanding the role of institutional investors, and deregulating M&As), and (iii) intensify competitive pressures (by deregulating FDI, discontinuing the import diversification system, and revising the bankruptcy law).

The financial sector reform also had two objectives: quickly normalizing the financial system through restructuring, and rebuilding a financial safety net to prevent future crises. To normalize the financial system, the state quickly restructured financial institutions, injecting capital into institutions capable of creating systemic risks or winding down institutions that posed little such risks. To rebuild a financial safety net, the government created a consolidated regulatory agency with oversight on banking, securities, and insurance industries. In addition, it made criteria for non-performing loans more stringent, and established the Korea Asset Management Corporation to purchase and dispose of financial institutions’ impaired assets. To accomplish financial sector reform, a fund equivalent to 35% of GDP was raised from bond issues, international lenders, state property holdings, and public funds.

To reform the labor market, large-scale layoffs of redundant workers for managerial reasons, including M&As, were agreed to by a newly established tripartite commission, and relevant laws

were revised. Also, restrictions on the use of temporary workers were reduced. On the other hand, civil servants associations and teachers' unions were legalized, and the political participation of labor unions allowed. These measures did little to enhance labor market flexibility, but restored the basic rights of workers and resolved nationwide industrial relation disputes.

To reform the public sector, central and local government employment was cut drastically, a new prudential regulation body was created, and a large-scale privatization and restructuring program was carried out. In addition, efforts were made to redefine the role of government and improve its capability, such as establishment of the Regulatory Reform Commission, which sought to reduce regulations by half.

The reforms undertaken by the government and business sectors in response to the 1997 crisis, as well as Korea's accumulated foreign reserves and current account surplus, helped cushion the Korean economy from the 2007 global economic crisis. Sudden capital outflows caused a severe credit crunch in the financial market, the stock market plunged by about 41% in 2008, and the Korean won depreciated by 40% against the dollar between October 2008 and February 2009. Korea's total output shrank by 4.5% in the 4th quarter of 2008 (17% in annual terms).

The government took prompt monetary and fiscal policies. First, the government and central bank provided a large amount of foreign currencies to the banking sector, offered state guarantees for new foreign borrowing, and signed currency swap accords with the U.S., Japan and China. In addition, the central bank slashed its policy rate sharply from 5.25% to 2% and expanded domestic liquidity.

Second, the government adopted an expansionary fiscal policy. On top of the tax cuts announced before the crisis, the government introduced a supplementary budget and increased annual spending by 14% two years in row, resulting in a fiscal deficit of 4% of GDP in 2009. It also prepared recapitalization schemes to strengthen financial institutions' health and to facilitate corporate sector restructuring. The government furthermore announced a plan to expand credit guarantees for SMEs, and reduced the burden of home equity loans by extending the grace and repayment periods, and offering guarantees equivalent to the decline in the housing prices.

The Asian and global crises demonstrated that Korea's exposure to external shocks has increased considerably. As the trade to GDP ratio exceeds 100% now, Korea's exposure to external risks will rise. An external crisis can break out with little prior warning, complicating efforts to safeguard the stability of the domestic financial market. Moreover, Korea's fiscal health is deteriorating. The central government debt rose to 30% of GDP in 2006 and, after stabilizing in 2007-08, increased again in 2009 due to the global crisis. In the future, Korea's aging population will accelerate government spending for welfare (especially for pension and health care), and reunification with North Korea would worsen fiscal health.

### **Inequality, Welfare, and Social Policy**

Korea's fast economic growth since the 1960s was accompanied by relatively stable income distribution. Increasing job opportunities offered by industrialization helped many people escape poverty. In fact, Korea had achieved relatively equitable growth until 1990. However, income distribution became less equitable in the early 1990s and worsened after the Asian crisis. The Gini

coefficient increased from 0.25 in 1992 to 0.33 in 1999 and then declined, but rose again to 0.33 in 2007. Explanations for the trend are; (i) globalization and the rise of a knowledge-based economy that puts low-skilled workers at a greater disadvantage, (ii) growing productivity gaps between manufacturing and services, HCs and light industries, and large and small businesses, (iii) stagnant employment growth, (iv) an inadequate social safety net, and (v) an aging population.

During the 1960-80 period, although government's top priority was economic growth, and welfare programs received low priority, several steps were taken to build a proper social safety net system in Korea. The Livelihood Protection Act was introduced in 1962, and pension acts covered military personnel, government employees, and teachers. The first social insurance program, the Industrial Accident Compensation Insurance (IAC) Act, was enacted in 1964. A compulsory health insurance system was introduced for private sector workers in 1977 and for government workers and teachers in 1979. Thus, basic social security systems were introduced during the period, but were quite limited in scope.

State-led industrialization produced various social problems in the late 1970s. Income distribution got worse, especially when government actively promoted the HCs at the expense of macroeconomic stability. The poor were more negatively affected by rising inflation. Also, as the living standard improved, the public paid more attention to income gaps between the rich and poor and between different regions of the country, and demanded more effective welfare programs.

In the 1980s, the government pursued stabilization and economic liberalization on the one hand, and expanded welfare programs on the other hand. Once fiscal balance was restored through fiscal consolidation in 1987, the government began to increase spending rapidly in response to the growing demand for public services, especially for social services (health, education, and housing) and infrastructure. This trend was escalated on the basis of the popular demand for democracy and the competitive bidding by democratic parties for a higher level of welfare services. General government spending rose from 18% of GDP in 1987 to 30% in 2000. In the 1990s, the government spending on economic affairs and education increased rapidly.

Therefore, more comprehensive social security systems were introduced during the 1980s. The community-based health insurance program covered both rural and urban residents, while the company-based health insurance program that started in 1977 extended its coverage, resulting in a universal health insurance system (HIS) in 1989. The National Pension Scheme (NPS) was introduced in 1988. The Employment Insurance System (EIS), which provided both unemployment benefits and a group of Active Labor Market Programs (ALMP) (such as wage subsidies, vocational training and employment service), was also introduced in 1995, completing all four types of major social security schemes. In addition, a massive housing program was launched to increase the housing stock and rental housing to low income households, raising the housing supply ratio from 71% to 79% between 1989 and 1993.

The Asian crisis in 1997, when the poor were more adversely affected and unemployment rates skyrocketed from 3% to 7%, exposed weaknesses in the Korean social safety net and played a catalytic role in its subsequent maturity. The NPS was made universal in 1999, and the EIS was expanded to cover all workers in 1998. Public assistance to the destitute, the elderly, the handicapped, and for pre-school age child care were also increased. In particular, the National Basic

Livelihood Security Program (NBLSP) in 2000 guaranteed the minimum living standard for the whole population by providing public assistance to households below the poverty line.

Since the social safety net in Korea expanded and matured in a relatively short period, it faces a number of difficult challenges. The first challenge is to improve the system's effectiveness in reducing poverty and inequality. Relative poverty in Korea is rather high (15% in 2007) among OECD countries, but the role of the tax and transfer system is extremely limited (2 percentage points). This ineffectiveness may originate from many factors. However, some important ones are the short history of the social safety net (such as the NPS), low coverage (especially by the IAC, EIS and HIS) due to the high degree prevalence of self-employment and temporary employment in the Korean labor market, and low benefit levels caused by spreading scarce resources thinly over a large target population. (The Basic Old-Age Pension, begun in 2008, offers public assistance for the low-income elderly. In 2010, 70% of those age 65 or older were given a benefit of about \$80 a month for a single person and \$130 for a couple in a country with per capita income of about \$1,600 dollars a month.)

The second challenge is to minimize the adverse effect of the tax and transfer system on work incentives, as observed in the NBLSP. To reduce the disincentive to work, the Earned Income Tax Credit system (2008) supplements the earnings of the workers with low income above the poverty line with cash benefits. However, its coverage is still limited.

The third challenge is assuring the long-run sustainability of the social safety net, especially the NPS and HIS.

The NPS is expected to run out of savings by 2060 even with the declining replacement ratio (40%). The government is contributing 15% of HIS revenue every year. In view of the development of more expensive technologies and equipment, and the aging population, the government's health spending is expected to rise further. The government's welfare spending has been rising rapidly, exceeding economic affairs and education spending, which traditionally had the largest share. Korea's political parties are competitively proposing larger and more generous welfare schemes. These trends would force the government to redefine the respective responsibilities of individuals and the state in the future social safety net. The state will have to focus more on basic coverage, quality and equity aspects of services, and individuals and the private sector should be asked to assume more responsibilities to enrich the quality and benefit aspects.

### **Climate Change and Green Growth**

With the advancement in economic structure and increasing global attention to environmental issues, the general public expects that the quality of life should improve. The government has tried to consider environmental and economic needs simultaneously. In 2007, the government adopted the emission trading system to encourage the voluntary participation of businesses in reducing greenhouse gases. It also promoted the commercialization and use of low-polluting vehicles. In 2008, the new government decided to concentrate on a management system for green growth. It aims to manage greenhouse gases, recycle resources, develop environment-friendly industries and technology, and strengthen the ability to adapt to climate changes. The government enacted the

Environmental Health Act, which aims to establish environmental quality standards and monitor environmental pollutants. It also overhauled land and urban planning to take greater account of environmental factors, and implemented a large project to restore four main rivers. Also, the government established a green growth and climate fund to assist countries in Southeast Asia.

Such initiatives received global recognition and helped the government host international organizations, such as the Global Green Growth Institute (GGGI) and the Green Climate Fund (GCF), in Korea. The GGGI is an international research institute, and the GCF is an international financial agency for green growth and climate change reduction and adaptation, which had accumulated \$30 billion by 2012 and is to mobilize \$100 billion every year by 2020.

### Conclusion

This case study of Korea's development highlighted the interconnectedness of the thematic issues and the importance of sequence in tackling them. Although the speed of Korea's transformation was extremely fast, its development sequence was similar to that of Western countries. Initially, industrial growth enjoyed the overriding priority, followed sequentially by efforts to rescue and prevent crises, promote equality and welfare, and finally alleviate climate change and environmental degradation. Also, the government tried to address inequity not by radical redistribution policies, but mainly by social protection measures. In these senses, Korea's development was not an exception to the prevailing global development norm. The real challenge to MICs is to find a model that can tackle all four thematic issues in a short period of time without incurring serious adverse effects.

\*This study draws heavily on Sakong Il and Youngsun Koh (eds.) (2010) *The Korean Economy: Six Decades of Growth and Development*, KDI: Seoul. April 15, 2013

## II. Inclusive Growth and Competitiveness

### 1. Government Policies and Export Promotion

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*"We cannot afford to forget that public order, personal security, economic and social progress and prosperity are not the natural order of things, that they depend on ceaseless effort and attention from an honest, effective government, that the people must elect" Lee Kuan Yew (cited in Asiodu, 2013).*

*"The rise of the South has resulted not from adhering to a fixed set of policy prescriptions, but from applying pragmatic policies that respond to local circumstances and opportunities—including a deepening of the developmental role of states, a dedication to improving human development (including by supporting education and social welfare) and an openness to trade and innovation". (HDR, 2013)*

*"Today, as a result of reduced trade barriers and lower transport costs, the production of manufactures is fragmented across borders, with many countries trading intermediate goods. And changes in information technology have made services increasingly tradable. The result has been a remarkable rise in intra industry and intra firm trade. Developing countries, particularly in Asia, have ridden these shifts to great advantage." HDI, 2013*

The above quotations summarize some of the changing perceptions on the role of the state in development process as well as the increasing importance of the South in the global economy. Emerging Middle Income Countries (MIC) has adopted different routes, phasing and timing of strategies and development policies. Usually exports promotion has played a significant role in this process.

The empirical evidence on the links between exports and growth, while quite suggestive is not conclusive (Hill, 1994), however, there seems possibly a stronger relationship between manufactured exports and growth. Many MIC rising on the wave of globalisations, have moved up rapidly on the ladder of exports and trade in general. Several of them have broadened both exports compositions as well as diversify their exports market. According to the HDR (2013), between 1995 and 1996, only 6 developing countries – China, Malaysia, Thailand, Brazil, India and Turkey have substantial trading relationship with over 100 trading partners. By 2011, the number has increased to 15. New entrants include Indonesia, Vietnam, South Africa, Ukraine, Egypt, Pakistan, UAE, Mexico and Morocco.

The rising trade, investment, finance and technology transfer among the countries of the South is part of the globalisation. However, exogenous factors like geography, cultural affinity, and natural endowments can also not be ignored. The pattern observed previously in the North South trade is gradually replicating itself also in the new South South trade relationships: few countries are

exporters of manufactured goods, while a vast majority continues to export primary and natural resource intensive products. This will be one of the important challenges of the future.

Export diversification has remained important policy objectives of many countries from the South. Ideas have been borrowed from successful countries or imposed by institutions controlling global trade and finance. Most policies are market led policies embodied in the famed Washington Consensus (WC): Macroeconomic stability (lower inflation, lower budget deficit/GDP, flexible labour and capital market) , a more stable real exchange rate, improved governance, reduction in anti-export bias, growing linkage with global economy, retreat of government from the commanding heights of the economy, democracy and several export promotion initiatives (export promotion councils, export processing zones, import duty rebates, duty drawbacks, export credit guarantee schemes, etc).

However, the results from the above initiatives are mixed: while economic growth rate has increased remarkably, poverty and employment remain weak. In addition, the economies of most of the countries remain undiversified, export structures are highly concentrated both in terms of composition and to some extent markets, and in the case of Africa, her share of global trade is pathetically below 4 per cent. Domestic market rather than exports become major drivers of growth, reducing incentives for efficiency. In addition, the external environment in which some of the current countries developed has changed.

The natural question that follows is has the market failed to trigger necessary export response, beyond those conferred by natural endowments? How do we promote a more balanced role between the state and the market in sharing the 'commanding heights' of the economy? In the words of Sachs, 2012, "Nobody in his right mind would advocate rigid central planning, but nobody should believe that complex challenges of science and technology, higher education, modernization of infrastructure, climate change mitigations, and the restoration of budget balance can be addressed without a careful, multi-year planning process within government".

Lessons from various government export promotion strategies have not proved successful in driving manufactured exports at least in the African context. Total and factor productivity growth rates remain low and the countries remain globally uncompetitive. In my view it is not as if the government policies are entirely inappropriate, it is simply that the policies to promote manufactured exports calls for interlinked policies, involvement of several stakeholders, and principle of collective responsibility in the government. It is precisely in the areas of science and technology, research and development, improved quality of education, health and infrastructure, efficient and effective institutions, areas that market are most likely to underproduce or malfunction, that government has retreated.

The outcome of the above is seen in the inability of African countries to take advantage of forces of globalisation like their counterparts in other parts of the developing world. This is needed for them to reduce dependence on primary exports and prepare for the chain-production, intra-firm, intra-industry trade of a globalizing world. The increasing significance of infrastructure, quality and cheap labour, efficient service delivery in enabling manufacturing, and the potential of new energy technologies to create jobs and diversify exports are opportunities the MIC, especially in Africa must prepare themselves for.

## Recommendations

1. Review extant laws setting up export promotion agencies and address other inhibiting factors like poor funding, poor staffing, lack of autonomy, timely implementation of incentives and constant interactions with key stakeholders
2. Address political economy of reforms (legislative/judicial buy in into reform agenda, commitment at the highest level of government, political support for reformers and factoring in the interests of potential losers in design and implementation of reform)
3. Remove barriers to Doing Business (the most important business of government is to provide the supportive environment for entry and exit of business, competitiveness of firms and security of investment and reduce business uncertainty, efficient and timely service delivery by government agencies)
4. Governance Issue (rule of law, respect for the sanctity of contract, property rights, efficient and prompt administration of justice, competent and effective government, zero tolerance for corruption)
5. Return to Planning and submission to the discipline of planning, respecting pre-determined priorities in the utilization of national resources. Adequate monitoring and evaluation of pre-determined targets with appropriate rewards and sanctions
6. Provision of adequate and qualitative Public Goods ( Research and Development, investment in science and technology, training and capacity development, high and qualitative education, good roads, security)
7. Provision of Support Services (ICT, power, export market information services, aligning diplomatic and economic interests).
8. Concerted efforts by the MIC to influence the governance structure of institutions regulating global trade. The MICs must work together to push back the anti-trade tendencies and postures in the developed countries

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## 2. New Developments in the World Economy: A Tough Agenda for MICs?

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### Introduction

This presentation briefly comments on the following issues. First it outlines the present extraordinary state of the world economy which departs much from previous historical experience. This refers specifically to the factual observation that developing countries have grown at a much faster rate than the developed countries since, at least, the beginning of the new millennium. Secondly, the paper will comment on the lessons to be drawn from the experience of Korea, the most successful industrialisation story in the history of mankind. Thirdly, the role of the government and of privately-owned large firms in the Korean economy will be scrutinised. Fourthly, the mechanics of knowledge-sharing between developing countries will be analysed. Fifthly, the role of trade unions, labour and the struggle for democracy in the evolution of South Korea's economy and polity will be examined. Sixthly, the role of competition and competition policy in Korea will be discussed together with their implications for policy for other countries. Finally, a brief conclusion will be offered. To avoid misunderstanding, it may be noted that the above points do not necessarily convey an order of priorities or of economic significance.

### The extraordinary state of the world economy

We are living through extraordinary times. During the first twelve years of the new millennium an unusual event has taken place – developing countries have expanded at a much faster rate than developed countries. Five developed countries (US, UK, France, Germany and Japan) achieved an average growth rate of only 1.50 per cent between 2000 and 2012. This compares with the corresponding growth rate of five emerging countries (India, China, Brazil, South Africa and Russia) of nearly 6 per cent. India and China, the two most populous countries have done particularly well. India achieved average annual growth rates of over 7 per cent in the first twelve years of the new millennium while the corresponding growth rate of the United States was a third of that number. China similarly had a stellar growth performance.

Other non-BRICs countries such as Colombia, Thailand, Indonesia, Malaysia, Mexico have also performed much better than the rich countries. Indeed, on the basis of this data, one might argue that the so-called global crisis has affected only the advanced economies while the leading developing economy countries have enjoyed a great leap forward rather than crisis during the first decade of the new millennium (Fennel, Kaur and Singh, 2013)

Excellent performance of the developing countries is one of the most encouraging features of the current crisis. It is not only desirable in itself, but their faster growth rate also helps the world economy. The superior performance of developing countries, as in the current crisis, is a new departure. Not too long ago, it used to be an article of faith among scholars that in a global economic and financial crisis, it is the periphery countries which suffer a prolonged slow-down or

worse while the centre takes care of itself. The story in the present crisis seems to be quite the opposite. Why should this be so? An important related issue is whether the good performance of the periphery can be sustained.

Here there are conflicting voices from unexpected quarters. The IMF suggests that the improvement in the position of the periphery during this crisis is their growing ability over the past two decades to absorb shocks. The organisation went on to observe, “Developing countries’ improved performance is explained by both good policies and lower incidence of external and domestic shocks” (IMF, 2012). On the other hand, Yilmaz Akyuz, chief economist of the South Centre in Geneva, a developing country think tank, argues that the good performance of the southern countries during the crisis has been largely due to favourable external factors e.g. commodity price rises, increases in capital flows (including remittances), (Akyuz, 2013). However, it can also be argued that developing countries learned and internalised the lessons from their previous experiences with the global crises. They improved their macroeconomic management of the economy markedly, paid close attention to the current account balance, and accumulated reserves to be in a position to run counter-cyclical monetary and fiscal policies during the times of the crisis.

In the most recent period, there has been a reduction in growth rates in most MICs as well as in advanced countries. China’s growth rate has fallen from 12.7 per cent in the year 2006 to 7.9 per cent in 2012. Brazil’s rate has fallen from 4 per cent in 2006 to 2 per cent in 2012. The fall in Indian growth rate, which has been much criticised at both home and abroad, has nevertheless not been any greater than in other BRICs.

However, the changes in growth rates in rich countries because of their economic downturn, has been even more negative. The average growth rates recorded for the period 2006 - 2012 range from 0.47 per cent per annum in Japan, 1.06 per cent in the US, 0.40 per cent in the UK and 1.51 per cent in Germany. The much decried Indian growth rate of 5.9 per cent for the same period of 2006-2012, looks quite healthy in comparison. However, this necessary correction to the public perception of Indian economic decline is not to encourage complacency. Rather, it is to agree with much recent research that neither India nor China, nor India-China together, can be the locomotives to pull the world economy out of its post-2007 economic decline. This task can only be done by the US and Eurozone economies when they manage to lift themselves out of their current malaise.

### Lessons from the experience of Korea

We take up now the epic story of South Korean industrialisation. In 1960 South Korea was one of the poorest countries in the world, with a per capita income of about one-hundred US dollars. Its economic prospects were regarded as being so unpromising that the US congress recommended the country should be given humanitarian aid rather than the normal foreign aid for economic development. However, in a mere 30 years the country catapulted into the ranks of OECD countries and within the space of 50 years it has achieved a per capita income of twenty thousand US dollars.

Unfortunately, until 1990, the economic history scholarship for East Asian countries was dominated by neo-classical ideas and interpretations which were endorsed by the Bretton Woods institutions.

The conventional wisdom was that the South Korean government did not intervene much in the economy. Professor Béla Balaasa (1988) best summed up the analysis of the neo-classical school as well as that of the Bretton Woods institutions in the following terms, “The above remarks are not meant to deny the role of government in the economic life of East Asia. But, apart from the promotion of shipbuilding and steel in Korea and a few strategic industries in Taiwan, the principal contribution of government in the Far Eastern NICs has been to create a modern infrastructure, to provide a stable incentive system, and to ensure that government bureaucracy will help rather than hinder exports.”

Similarly, the World Development Report (1991) argued that experience shows that the government works best when it follows a market friendly approach to development. This report is a seminal document as it represents what the World Bank economists had learnt up to that time from forty years of development experience. To save “market friendly” from being a mere tautology, to their credit, the World Bank economists defined it in fairly precise terms as follows:

- “Intervene reluctantly: Let markets work, unless it is demonstrably better to step in ...[It] is usually a mistake for the State to carry out physical production, or to protect the domestic production of a good that can be imported more cheaply and whose local production offers few spillover benefits.
- Apply checks and balances: Put interventions continually to the discipline of international and domestic markets.
- Intervene openly: Make interventions simple, transparent and subject to rules rather than to official discretion.”

In a seminal and widely acknowledged contribution, Alice Amsden (1989) pointed out that this was a fundamentally incorrect reading of the South Korean economy and economic history. Her book went on to illustrate with chapter and verse the deep involvement of the South Korean government in all aspects of the country’s economy.

### **Role of the government and of privately-owned large firms**

How did it happen? Amsden’s explanation is by now common knowledge. The state took a leading role in economic development as befitted a developmental state. The government presided over a regime of subsidies, taxation and industrial policy to increase the rate of investment, to boost exports and to achieve planned industrialisation. One of the notable characteristics of the South Korean narrative is that subsidies or special concessions were given to entrepreneurs and firms only in response to meeting strictly the performance targets set by the government. Often these were export targets, involving new products which were subject to huge uncertainty whether or not they would succeed. However, the firms produced them because they knew that if they followed the governmental edicts, they would be rescued by the government. Thus, the entrepreneurial risk was socialised. After denying for many years that there had been deep government involvement in many areas of economic activity, the World Bank’s 1993 Development Report explicitly acknowledged that there had been government controls in all directions. The Report stated:

“Policy interventions took many forms – targeted and subsidised credit to selected industries, low deposit rates and ceilings on borrowing rates to increase profits and retained earnings, protection

of domestic import industries, the establishment and financial support of government banks, public investment in applied research, firm – and industry-specific export targets, development of export marketing institutions, and wide sharing of information between public and private sectors. Some industries were promoted while others were not.”

However, the report goes on to suggest that such interventions, particularly in the sphere of industrial policy, had in general a limited effect. Some of these worked for some time in a few countries, but overall they were neither necessary nor sufficient for the extraordinary success of East Asian countries. Thus, according to the World Development Report 1993:

“What are the main factors that contributed to the High Performing Asian Economies’ (HPAE’s) superior allocation of physical and human capital to high yielding investments and their ability to catch up technologically? Mainly, the answer lies in fundamentally sound, market-oriented policies. Labour markets were allowed to work. Financial markets ... generally had low distortions and limited subsidies compared with other developing economies. Import substitution was... quickly accompanied by the promotion of exports...the result was limited differences between international relative prices and domestic relative prices in the HPAE’s. Market forces and competitive pressures guided resources into activities that were consistent with comparative advantage...”

In other words, the final policy conclusion was still essentially that of the market-friendly approach to development, albeit in a new packaging. Developing countries were recommended to seek their comparative advantage, to get the prices right, to have free-markets as far as possible.

### **Mechanics of knowledge-sharing**

One of Amsden’s important contributions was to provide building blocks to construct a new theory of the third world firm in late industrialisation, (Amsden, 2001/2007). She noted an empirical regularity about the operation of firms in countries with diverse cultures and governance systems. This regularity derives from the ubiquitous existence of large privately-owned conglomerate firms in developing countries all over the world. This is true of India, South Korea, Malaysia, Thailand, Jordan, Turkey, Pakistan, Brazil, Mexico and many other countries. These nationally owned and controlled, conglomerate firms had been the spearheads for competing in the international markets and have played a central role in the industrialisation of many countries.

The issue of corporate governance for the large third world conglomerates is important and is rather different from that of advanced country firms. The third world conglomerate firm makes perfect economic sense in a world where there are many missing markets. The result is that third world firms have to produce internally many of the goods which are not available in the market. This is one reason why the third world conglomerates are much more successful than has been the case with UK and US conglomerates which were favoured by the stock market at one time, but later fell into disfavour because of their poor performance.

### **Role of trade unions, labour and the struggle for democracy**

Students of Korean economic history have had great difficulties in dealing with the questions of labour rights, labour movement and labour markets during the South Korean industrialisation. It is

widely alleged that in the Korean industrialisation drive, human rights were ignored and labour was prevented from organising collective action and the weaknesses of the trade unions hindered the progress of democracy in the country. It led to political repression which was at times violent. Scholars of the South Korean economy such as Alice Amsden were criticised for supporting the regime through their writings which painted a very favourable picture of South Korean industrialisation. Amsden's response was that she strongly supported the struggle for democratisation in Korea and specifically she supported students who took a highly active part in the fight for a democratic political order. The transition to democracy has continued to evolve and today one can agree with Professor Amsden that South Korean people can not only take pride in their huge technological and economic advances but also in their democratic regime. It is arguable that without this fast industrialisation and the creation of a working class, democracy may have taken much longer to evolve in Korea.

### Role of competition

It was argued earlier in this paper that the MICs are faced with a tough agenda if they are to be successful in continuing with their fast industrialisation. The collapse of Eurozone and slow growth in the US makes it much more difficult for developing countries to maintain their growth rates. Dani Rodrik (2011), however, reaches the same negative conclusion but through a different route. He argues that it is the supply side which poses essentially insurmountable problems for poor countries. Fast growth, he suggests, depends on speedy growth of manufacturing-production and to a very limited extent on modern services. Only fast growth of manufacturing-production creates the dynamic economies of scale which lead to steady progress.

Ten years ago, Larry Summers presented a different paradigm based on the standard narrative pertaining to growth:

"I would suggest that the rate at which countries grow is substantially determined by three things: their ability to integrate with the global economy through trade and investment; their capacity to maintain sustainable government finances and sound money; and their ability to put in place an institutional environment in which contracts can be enforced and property rights can be established. I would challenge anyone to identify a country that has done all three of these things and has not grown at a substantial rate (Summers, 2003)."

Rodrik's response to this argument is stated in the following terms:

"...One of the paradoxes of the last two decades of globalisation is that its biggest beneficiaries have been those countries that have flouted its rules – countries like China and India that have effectively played the game by Bretton Woods rather than post-1990 rules (controlled finance, controlled currencies, industrial policies, significant domestic manoeuvring room). But as such countries become large players and turn into targets for emulation, the tensions become too serious to ignore. How we handle those tensions will determine not only the future of convergence, but the future of the world economy as well." (Rodrik, 2011).

The Republic of Korea did not follow a policy of maximum domestic competition or unfettered market-determined entry or exit of firms. The government in that country, if anything, went one

step further than the Japanese in actively helping to create large conglomerates, promoting mergers and directing entry and exit of firms, according to the requirements of technological-scale economies and world-demand conditions. The result is that the manufacturing industry of the Republic of Korea displays one of the highest levels of market concentration anywhere – whether among the developing or developed countries. The top 50 chaebols accounted for 15 per cent of the country's GDP in 1990. Among the largest 500 industrial companies in the world in that year, there were 11 Korean firms – a number as high as that of Switzerland.

The UN (1993, p. 43) observed in relation to the Korean industrial structure:

“Such a structure is the deliberate creation of the Government, which utilized a highly interventionist strategy to push industry into large-scale, complex, technologically demanding activities while simultaneously restricting FDI inflows tightly to promote national ownership. It was deemed necessary to create enterprises of large size and diversity, and to undertake the risk inherent in launching investments in high-technology, high-skill activities that would remain competitive in world markets. The chaebols acted as the representatives and spearheads of the Government's strategy: they were supported by protection against imports and TNC entry, subsidized credit, procurement preference and massive investments in education, infrastructure and a science-and-technology network.”

Nevertheless, there is ample evidence that the big business groups still exhibited highly rivalrous behaviour (Kim, 1992). This was because under rapid growth conditions, as well as under the rules of the game which the State had established, there was neither the incentive nor the ability for big business to collude. The Korean government went out of its way to ensure that big business did not collude by allocating subsidies only in exchange for strict performance standards (Amsden, 1989). After 1975, inter-group competition in Korea became even fiercer as each chaebol, or diversified business group, tried to qualify for generous subsidies to establish a general trading company by meeting government performance standards regarding minimum export volume and number of export products (Amsden and Singh, 1994).

It is also interesting to observe that as in the case of Japan the Korean government did not encourage multinational investment.

An important argument of orthodox thinking is the suggestion that most LDCs lack the institutional capacity to implement the State-directed industrialisation such as in Japan or Korea. This argument is plausible, but not necessarily valid.

The important point to note here is that the Japanese model was itself imitated by Korea and Taiwan. When Korea decided to embark on the Japanese model in the 1960s, as World Bank economists themselves admit, Korea did not have the necessary institutional capacity. The bureaucracy of Korea suffered at the time from a lack of skills and a deficit of competition ethos, as was indeed the case with the Kuomintang bureaucracy in Taiwan. Yet these countries were able to create the right kind of bureaucratic structures required and other institutions necessary for implementing the Japanese model. If these institutions could be created by Korea and Taiwan, and later on by Malaysia or Indonesia, surely it must be possible to establish them as well in many other MICs?

## Conclusion

A fundamental argument of this workshop is that developing countries have much to learn from each other. There should therefore be south-south cooperation and collective learning from developing countries' own experiences. The scope for such learning and its potential benefits are enormous. Several models are available and can be useful. Specifically, developing countries can follow the OECD model, which brings together the top civil servants from various countries in any particular specialist area (say transport or food-grain distribution) for an exchange of views on optimal policy formation and implementation. Such meetings can be held at higher ministerial level as well as at lower levels. This is by no mean the only method of achieving cooperation between the MICs. There are variety of other methods involving education, science, technology among other fields which can also contribute greatly to mutually beneficial cooperation and exchange. I end this brief presentation by noting an extremely important point that the south-south cooperation is not intended to replace north-south cooperation but rather to supplement it with other useful types of collaboration.

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### III. Inclusive Growth and Competitiveness

#### 1. Inequality, Welfare and Social Policy in Middle-Income Countries

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MICs are heterogenous, internally diverse and differentiated. They have varying historic trajectories and legacies, and they operate under very different social, economic and institutional conditions. Treating them as a group may be prone to just as many problems as those related to categories like "developing countries". There are certainly some common challenges, but it is not evident that these challenges are confined to MICs; nor is it the case that these are consistently evident in equal degrees across MICs.

Two further initial comments may be useful as background. The idea of a "middle income trap" is problematic, especially as there is no clear conceptual argument for such a trap. Perhaps more significantly, the notion that people with per capita daily consumption in the range of \$2-5 (even when measured in highly problematic PPP terms) constitute a "new middle class" is breathtaking in its insensitivity. By far the greater population of MICs (who do actually fall in the category) are working people whose material lives are fragile and vulnerable, whose standards of living would place them squarely below the poverty line in all developed countries, including those currently experiencing financial crisis and austerity. The very use of such loosely defined terms is not just methodologically suspect; it conveys a false sense of complacency about actual material conditions in these MICs.

What is evident, however, is that growth processes in many so-called MICs have contributed to increased economic inequalities that often reflect and reinforce social inequalities. Once again, this is not true across all MICs: there have been reductions in inequality in many countries of Latin America in the past decade. But in most countries, especially in developing Asia and Africa, inequalities have crossed bounds of social tolerance and have become both economically and socially dysfunctional. Gender inequalities in particular have often been further entrenched by patterns of growth that rely on segmented labour markets and the unpaid and underpaid labour of women to achieve higher rates of profit and thereby drive accumulation, and this has perhaps been most evident in developing Asia.

The recent Latin American experiences have shown that reasonably impressive growth performance can be combined with reductions in inequality across many dimensions, through a combination of progressive macroeconomic strategies, labour market and minimum wage interventions, policies to limit concentration of control over assets and resources, and social programmes. This suggests that piecemeal approaches based on single initiatives are unlikely to be successful; they must be part of a wider economic and social policy framework that is oriented towards inequality reduction. This in turn requires measures that are transformative in orientation rather than just marginal or incremental, with the ultimate aim of zero discrimination.

At the national level, one critical strategy for reducing inequalities is that of ensuring universal access to good quality basic goods and services: food, housing, basic amenities like water and

energy, health services, education, social protection. This is important and needs to be reiterated because currently many countries - both rich and poor ones - are moving away from universal provision and recent moves towards fiscal austerity have made matters much worse. But we also have evidence of countries where attempts to move towards such universal provision led to significant reductions in inequality, over the 20th century in the Nordic countries; more recently in several countries in Latin America.

This can be seen as part of a "social protection floor" - an integrated set of social policies designed to guarantee income security and access to essential social services for all, paying particular attention to vulnerable groups and protecting and empowering people across the life cycle. It includes guarantees of:

- basic income security, in the form of various social transfers (in cash or in kind), such as pensions for the elderly and persons with disabilities, child benefits, income support benefits and/or employment guarantees and services for the unemployed and working poor;
- universal access to essential affordable social services in the areas of health, water and sanitation, education, food security, housing, and others defined according to national priorities.

The point is to universalise access to benefits in health, pensions, unemployment, child care and primary education, and make them individual rather than household based. This obviously contributes more towards reducing poverty, containing inequality, sustaining equitable economic growth and encouraging greater empowerment and autonomy for women. Within such a broad social protection floor approach, it is important to ensure that provision reaches the last sections of the population that are typically excluded. So it is particularly necessary to recognise, address and work to reduce or eliminate the existing structures of discrimination and exclusion. These structures can relate to social categories such as gender, ethnic and other divisions; regional or locational characteristics; or personal features such as age or disability. Explicit recognition of such structural forces is critical to the reduction of inequalities of opportunity. So in addition to a policy of universalism, specific interventions is required in different contexts: affirmative action; targeted public investments in underserved areas and sectors; access to resources that are not conditional; conscious understanding of how policies are implemented on the ground with reference to the economic, social, legal, administrative and cultural realities.

Ensuring resources for this means that fiscal policies must be explicitly under consideration, particularly tax policies that seek to improve collection from sectors and agents that have benefited disproportionately from aggregate income growth. This does not necessarily require higher tax rates - better and more effective implementation of existing tax laws and closing tax loopholes can be even more effective, as some recent examples from Latin America and elsewhere indicate. The important point is that such policies of public spending are not only affordable but can - in the long run - pay for themselves, by enhancing the productiveness of the labour force, the resilience of society and the stability of the polity. In addition to this, monetary and financial policies need to be re-oriented, to encourage greater inclusion of those excluded and to make the financial system one that provides financial security and possibilities for stable intermediation between savings and investment, rather than lead to vulnerability and enhanced possibilities of economic disruption. So measures are required to control financial activity and direct it towards socially desired goals. Once

again, international support for such measures by national governments is necessary, given the much greater global integration of finance today.

A major part of existing inequalities within countries today results from unequal control over assets. These include natural resources such as land, water, minerals and other fruits of nature, as well as produced productive assets and financial assets. The increasing concentration of all such assets needs to be countered by explicit policies to reduce it and spread the access to resources and assets more equally. This includes better distribution of the rents from natural resources, which is a strategy that is increasingly being sought in a number of countries. It also includes more taxation directed to inherited wealth and other forms of capital gain.

Inequalities between countries currently account for the greater part of global economic inequality. A vital concern in developing countries is employment diversification to enable the shift of workers to less fragile and better remunerated activities with safe and healthy working conditions. Strategies to reduce wage inequalities (through enforcement of progressive minimum wage policies and decent work conditions and so on) are required. Once again there must be recognition and redressal of inequalities in wages that are generated not just by types of work but by patterns of social discrimination and segmented labour markets, particularly those that create gender gaps in wages and working conditions. The growing numbers of self-employed workers requires explicit attention to their conditions, with a focus on raising aggregate productivity through measures to improve productivity at the bottom rather than just at the top.

These national strategies require an international context that provides support to such measures and is conducive to progressive strategies implemented by governments. This must include acceptance and promotion of efforts made by poor and developing countries to diversify their economies and move up the global division of labour, to ensure fair access to resources and equitable distribution of the rents from extraction of nature, to ensure just and effective tax systems, to control finance to ensure social goals and stable economic environments. This means that international treaties and agreements must be framed or reworked to be sensitive to these requirements, including those relating to trading rules, investment agreements, intellectual property regimes, and financial flows. The monitoring and control of the activities of large corporations that now have a global reach is important, especially when these impinge on human rights and help perpetuate or aggravate inequalities.

In the current global context, this suggests another crucial role of what is now called “South-South cooperation”, because the current international economic and financial architecture is not so conducive to progressive strategies and developing countries, including MICs, are constantly forced to work around them rather than with them.

## 2. Social Protection and Labour Markets in Middle Income Countries

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The paper reviews the expansion of antipoverty programmes underway in middle income countries and assesses the implications for labour markets and welfare institutions (Barrientos, 2006, Barrientos, 2012, Barrientos, 2013, Barrientos et al., 2010).

### Rapid growth of antipoverty transfers

The most significant recent change in antipoverty policy in developing countries has been the fast growth of large scale programmes providing direct transfers in cash and in kind to families and individuals facing poverty and vulnerability. The spread of antipoverty transfer programmes is astounding. Estimates suggest that by 2010 between 750 million and 1 billion people in developing countries lived in households receiving transfers.

Antipoverty transfer programmes show considerable diversity in low and middle income countries, reflecting local learning about what works in poverty reduction, economic development, institutional capacities, and political processes and priorities. They include categorical transfers for households or individuals in poverty, like social pensions or child and family allowances; transfers combined with asset accumulation, like human development conditional cash transfers, employment guarantees and asset protection transfers; and integrated antipoverty transfers, like BRAC's Challenging the Frontiers of Poverty Reduction: Targeting the Ultra-Poor.

Mexico's 1997 Progresa/Oportunidades developed out of a concern with the impact of agricultural liberalisation on intergenerational poverty persistence in rural areas. Its design, including transfers to families with children conditional on school attendance and primary health care utilisation, was a reaction to ineffective food subsidies. India's 2005 National Rural Employment Guarantee Scheme, providing 100 days employment on demand to unemployed heads of household, is a response to persistent poverty in rural areas designed around existing state level employment guarantees. South Africa's 1998 Child Support Grant extended social assistance to children in poor households, and was influenced by the perceived effectiveness of old age transfers. China's 1999 Minimum Living Standards Scheme was initially set up to provide assistance to older and disabled urban residents in poverty, but was swiftly extended to support growing numbers of unemployed workers from recently liberalised state owned enterprises.

### Characterising social assistance in the South

The rapid growth of antipoverty transfer programmes has moved ahead of the conceptual frameworks with which to study them, especially in international policy debates, and some briefs comments on approach and terminology will be helpful.

From an institutional perspective, antipoverty transfers are one of the components of social protection. Social protection includes social insurance which consists of schemes financed by contributions from workers and employers aimed at addressing life course and work contingencies;

social assistance which includes tax-financed programmes addressing poverty; and employment programmes, whether 'active' or 'passive'.

In developed countries, welfare states have been successful in integrating the provision of basic services, like health and education, with social protection institutions. For the majority of countries in the North, social insurance and service provision are the largest components of welfare states and social assistance can be a relatively small and residual component.

In developing countries, social insurance schemes and employment programmes are limited in coverage. Even in Latin America and the Caribbean, where social insurance schemes can be traced back to early 20th century, coverage is restricted to workers in formal employment around one half of the labour force. In Asia and Africa, a very small minority of workers are in formal employment and social insurance is small scale.

The recent expansion of social protection in the South has concentrated on antipoverty transfers, the social assistance component. It is best to approach antipoverty transfer programmes as embryonic social protection institutions, rather than as short term development projects. In just a decade, social protection has become widely accepted in developing countries as an essential component of an inclusive development strategy. Growth delivers economic opportunity and basic services support productive capacity, but without social protection they are unlikely to reach the poorest.

### Explaining the growth of antipoverty transfers

The growth of social protection programmes has been swift in middle income countries, which is of great importance given the fact that a majority of poor people in the world lives in middle income countries. Democratisation and enhanced fiscal space are key drivers for the expansion of social protection.

Several factors generate political consensus behind social assistance: (i) strengthened solidarity values in society; (ii) evaluations showing effectiveness of antipoverty transfers; (iii) raised vulnerability leading the non-poor to set a higher value on a 'social minimum'; (iv) the role of fiscal pacts given natural resource revenues and consumption taxes are the primary revenue source for governments in the South; (v) the perceived need to reduce the 'strains of commitment' among disadvantaged groups.

The diversity in social assistance programmes in the South confirms the primacy of national policy and political processes in the emergence of social protection in each country.

### Social Assistance, Labour Markets and Welfare Institutions in the South

The growth of social assistance in middle income countries has important implications for the workings of labour markets and for the evolution of welfare institutions.

Research on the effects of social assistance programmes on labour market outcomes has identified three main findings. (i) Labour supply responses to social assistance transfers are broadly positive. Human development focused programmes targeting children's schooling reduce child labour, although often the reduction is less than proportionate to the increase in schooling. Social pensions

reduce the labour supply of elders, even though this is seldom a requirement for recipients. Labour supply responses among adults of working age are marginal and often positive. (ii) Social assistance programmes can facilitate a welfare improving re-allocation of household productive resources. A guaranteed minimum income can facilitate job search, labour migration, and improve labour earnings; but the effects are highly dependent on household conditions. (iii) Social assistance programmes can lead to improvements in human capital, with the effects being stronger among programmes with explicit human development objectives.

The distributional effects of social assistance programmes are important but under-researched. Well-designed and scaled up programmes can achieve significant reductions in poverty, especially the poverty gap. The poverty reduction impact of the programmes is stronger in the context of inclusive growth. As programme transfer budgets are normally small – a fraction of 1 percent of GDP for human development programmes in Latin America – beneficiary selection is essential to programme effectiveness. At the same time, limited budgets militate against social assistance having observable effects on aggregate inequality. In middle income countries with significant social insurance, public subsidies to social assistance are a fraction of public subsidies to social insurance. A re-balancing of public subsidies with social protection and in favour of social assistance is highly likely to be welfare improving.

The growth of social assistance in middle income countries will shape in important ways the evolution of welfare institutions. Social assistance growth has been effective in supporting the inclusion of informal and low income groups within social protection systems. In Latin America in particular, where social insurance systems have been accurately described as ‘truncated’ before the new century, social assistance programmes have generated social and economic inclusion, albeit vertical rather than horizontal inclusion. Social assistance is grounded on a ‘citizenship’ principle in contrast to the ‘contributory’ principle which underpins social insurance. In practice, the citizenship basis of social assistance is far from solid and comprehensive in the South; but important advances have been made in this respect. The implications of grounding social protection systems on a citizenship principle, as opposed to a contribution principle need urgent attention.

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### 3. Poverty, the ‘New Middle Classes’ and Sustainable Development

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#### 1. Where are the world’s poor today?

One of the central challenges related to poverty today is that the majority of the world’s poor live in Middle Income countries. Up to one billion people live in extreme poverty (under \$1.25 per day) with an additional one billion earning between \$1.25 and \$2.00 per day. The primary reason for this rapid increase in the proportion of the world’s poor living in Middle Income countries is that rapid growth in national income, especially over the 2000s has led to a reclassification of a growing list of former Lower Income countries as Middle Income. In fact, 30 countries, including 5 populous ones, shifted into middle income status in recent years so that as of 2012 only about ¼ of the world’s extreme poor live in LICs.

The reclassification of countries from low to middle income, however, does not mean an end to poverty. Indeed, outside of China, the number of poor people in MICs barely changed, although the proportion of poor in the total population has fallen sharply. The shift can be seen most dramatically in China, where the proportion of the extreme poor has fallen from roughly 85% of the population in 1990 to roughly 30% in 2008.

#### 2. Challenges for the World’s Poor: Differences from Low-Income Countries

The poor in Middle Income countries present different challenges than LIC poor populations. While the critical issue is a lack of resources and capacity in LIC countries, MIC frequently have both sufficient resources and at least potential capacity to deliver services. As Andy Sumner has argued, the challenges facing MIC in addressing extreme poverty is less about lack of resources and increasingly about national inequality, growth patterns and voice/governance especially in public finances.

The poor and extreme poor face a variety of problems, including growing gaps in consumption and opportunities between themselves and the rising ‘middle classes’, as well as geographic isolation, lending itself to the risk of LICs within MICs. Improved taxation and greater accountability in the provision of social services is vital to sustained reduction of poverty in MICs. The rise of CCTs as a new form of social protection offers some potential for reduction of poverty. But, there are limits. For example, the Commitment to Equity Project examining poverty reduction efforts in Latin America points to a number of issues, including: public spending on health and education has a greater equalizing effect than direct transfers in all countries in the Latin American sample; indirect taxes are regressive in a number of countries and offset the benefits of direct transfers; direct taxes are progressive in all countries in the sample, but in all cases represent very small percentages of total revenue. In short, much can be done to improve tax policy and public expenditure on health and education to address ongoing problems of poverty.

In political terms, work by Wendy Hunter and Natasha Borges Sugiyama on the attitudes of *bolsa família* recipients suggests that the institutional mechanisms of delivering social assistance may be even more important than the actual economic benefit. Surveys conducted in Northeastern Brazil point to strengthening of notions of citizenship and attention to good governance.

### 3. Who are the New Middle Classes?

If the poor stand to gain from improved tax policy and human capital expenditure, then much of the hope rests on the demands of the rising, new 'middle classes.' This new category includes roughly one billion people earning between \$2 and \$4 per day with yet another billion earning between \$4 and \$10 per day. In both absolute terms and as a share of total population, the growth of this group in the MICs has been nothing short of staggering, again with China leading the way by far. The percentage earning between \$2 and \$4 per day rose from 13.4% of the population of China in 1990 to over 32% in 2008 while the share earning \$4 and \$10 per day rose an astonishing amount from only 1.9% in 1990 to 31% of the population by 2008. Even outside of China, the growth in the shares of the population in the two categories among all developing countries was in the area of 30%.

There have been a variety of efforts to define, classify and characterize these new middle classes, including those focused on consumption patterns, ownership, access to key policy goods (such as pensions), political and social attitudes, as well as simply looking at income thresholds. While there is no consensus on how to classify this diverse group, it is important to highlight that they are not a 'middle class' in the traditional sense of the term as associated with older high income countries. Arguably the most important way they differ is that they are both much poorer than US or Western European middle classes and they are considerably more insecure. In fact, these 'middle classes' are one income shock away from a return to poverty. That may be a temporary factor, such as a health problem or health related cost, or it may be due to adverse weather and/or other factors affecting agricultural production. But, in any event, short-term losses of income may lead individuals or households to sell off assets or withdraw children from school in order to cope with the immediate circumstance. Converting capital, or potential human capital, into immediate cash trades off future earnings for short-term survival. Moreover, the weaknesses of pensions, health insurance, long-term disability or old age care all mean that 'middle class' households may lack the resources to maintain their incomes in times of adversity.

### 4. Sustaining Gains: The Challenges of Informality, Education and Health.

This last issue is a significant challenge to the sustainability of rising incomes. Ultimately, the promise of the rising middle classes lies in their potential contribution to growth through increased consumption and their contribution to improved governance and public investment in human capital through greater voice and accountability. Sustaining that depends on creating good jobs that pay better wages that in turn helps support greater and better public expenditure on vital social services. One concern is that the rapid rise in incomes, declines in the poor, and public sector spending are tied intimately to the commodity boom of the 2000s. To wit, Juan José Ruiz of the Interamerican Development Bank has charted the close link between fiscal revenues and commodity prices for commodity exporters and has highlighted in particular the risk to countries with public expenditures tied commodity-linked revenues rather than a broadened tax base.

In terms of the quality of jobs, the panorama varies dramatically across the MICs. In emerging Asia generally, levels of informality, for example, tend to be lower. But, 56% of employment in Latin America is informal, while emerging Africa, South Asia and Southeast Asia all also have high levels of informal employment. The OECD estimates that the rates of informality in India, Indonesia and

Pakistan are 83.4%, 77.9%, and 64.6% respectively, while 50.6% of employment is informal in South Africa. Informal workers do not contribute to formal systems of social insurance, such as pensions. But, informality is also a drag on productivity and an obstacle to improving wages and deepening the security of both low income and middle-income workers.

Variation on educational spending and performance is also considerable. Again, emerging Asia, led by China, performs much better on an array of education indicators such as PISA scores. One of the disheartening realizations is that educational improvements are difficult to attain, even when CCTs like *bolsa familia* or *Oportunidades* succeeds in increasing enrolments. Brazil's achievements under *bolsa*, for example, are considerable, but have had little consequences for PISA scores due to the much more complex challenges of improving education on the ground.

Health services is another key area to continued income improvements in MICs. Rising problems of disease such as HIV/AIDS, heart disease or diabetes represent substantial challenges to public expenditure. Diabetes in particular is sharply on the rise in conjunction with increased household consumption of food. For example, Eduardo Gomez has calculated that by 2025 the cost of providing insulin and pills for only 1/3 of China's diabetic population will equal half of the country's defense budget. Health care costs also tend to fall heavily on households in MICs. As of 2007, the out of pocket share of total health expenditures was 31% in Upper MICs and 53% in Lower MICs in contrast to only 14% in high-income OECD countries. Sustainable improvements in welfare therefore depend both on facing the challenges to public expenditure on health as well as the pressures on households.

In sum, the MICs have seen dramatic changes in the rise of the middle class and the declining share of the poor and indigent in their countries. Nevertheless, the majority of the world's poor do live in the MICs and their middle classes are a relatively poor and highly vulnerable group. Improved taxation, both in terms of efficiency and progressivity, increased investment in health and education, efforts to increase the levels of formality of employment, and improved voice and accountability are all critical elements of sustained growth and reduction of poverty and inequality.

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## IV. Economic and Financial Crises

### 1. “Addressing the Complexity of Macroeconomic Management in Middle Income Countries<sup>22</sup>”

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#### MICs have expedited reform to gain better access to the global financial markets

1. To confront more complex development challenges many MICs have expedited reform to modernize their financial sector and increase integration to the global financial markets, as well as adopted a more open and liberal capital account regime.
2. These steps have so far expanded private access to bank and non-bank financing, both domestic and foreign, helped reduce the gap between the available saving and the required investment, and allowed households, firms and Governments in MICs to smooth consumption over time. Moreover, through capital market development, reform minded Governments in MICs have gained more access to the much needed market development financing. As a result investment, both private and public, have increased as shown by the increasing investment ratios in MICs.
3. On the back of such robust investment outturns are capital inflows, which have surged up due to a better access to the global capital markets.

#### But with it, is an increasing complexity of macroeconomic management

4. Capital inflows that come with increased openness and advancement in financial sector development also tend to generate greater macroeconomic volatility and vulnerabilities. Connected to episodes of large upsurge in capital inflows are episodes of rapidly expanding monetary and credit aggregates, a persistent internal imbalance (i.e. persistent inflationary pressures), and a prolonged real exchange rate appreciation, which are all key ingredients for a destabilizing external imbalance (i.e. a persistently worsening current account outturns). Accordingly, episodes of large capital inflows tend to precede episodes of currency and balance of payments crises. Moreover, large capital inflows may also instigate increased trading of financial and real asset prices beyond what is warranted by their fundamental values. This could heighten risks to financial stability, particularly if financial institutions are unhealthy and the nature of the inflows is short, as this type of capital flows is exceptionally sensitive to the direction of global portfolio rebalancing.
5. In the aftermath of the 2008 global financial crisis, capital flows to MICs in Asia have continued to increase, tapping the growing market opportunities in the region. This trend is expected to continue in the medium term as Asia is projected to account for at least 1/3 of the global economy in 2020. In the absence of an appropriate policy mix, this upsurge in capital inflows

<sup>22</sup> Views expressed in this policy note do not necessarily reflect the views of the Board of Governors of Bank Indonesia. In preparing this material, the author has benefited from fruitful discussions with Firman Mochtar, Assistant to the Board of Governors, Bank Indonesia.

may lead to increased macroeconomic volatility and vulnerabilities in Asia's MICs. Accordingly, a relevant policy question for macro-financial policy makers in the region is: how to respond to the possible upsurge in capital inflows as MICs are migrating to a higher income country. Yet the answers to this common question are far from common.

### **Suggesting a common challenge in uncommon policy environments**

6. Upper Middle Income Economies. Notwithstanding their ability to implement a sophisticated monetary policy framework comparable to that in advanced countries, central banks in upper MICs with more advanced stage of financial development may find it difficult to contain rapid monetary expansion induced by large capital inflows and correct the ensuing macroeconomic imbalances, using the standard interest rate instrument. A tightening stance would induce further short term portfolio flows which are prone to abrupt and sudden reversals. At the same time without a sufficient tightening of the monetary condition, the appreciation of real exchange rate will persist, encroaching upon the competitiveness of the less efficient labor intensive domestic industries and export sectors.

7. Moreover, as countries are advancing into upper MIC status, the flows of FDI will tend to increase. Upper MICs are homes of expanding number of urbanized core middle class and emerging upper class population. This segment of the society in MICs is enlarging the size, diversity, and complexity of demand for goods and services both domestically and globally. More advanced MICs also have better pool of talented human capital and capacity to innovate. These are all pull factors for more sophisticated global manufacturers producing R&D and value intensive goods for domestic and global markets.

8. This continued FDI flows with increasing quality would improve the overall long run global competitiveness and productivity of the recipient countries. It will also provide the economy with more liquidity, and support lower interest rates, easing the overall credit condition in the financial markets. Households and enterprises will have greater opportunities to take on more leverage, the Government will have bigger access to development financing at cheaper rates, and investors can enter into new projects that previously would have been considered less feasible.

9. However this accommodative condition in the credit markets might give false perception on the actual level of risk and return in the economy. In other words, the ongoing credit condition may not be fully consistent with agents' underlying inter-temporal preferences, which may lead to overconsumption and mal-investment in certain sectors. These excesses in turn drive an economic boom characterized by a robust expansion of domestic demand. Yet this expansion may not constitute a genuine capacity expansion of the economy for it is largely cyclical in nature and not necessarily in line with the underlying preferences of agents in the economy, as it is being fueled by leverage financing and forced savings. Accordingly the boom is hiding a build-up of risks and could go bust at any moment.

10. A shift in domestic investors' expectation due to growing macroeconomic imbalances, i.e. inflationary pressures and a deteriorating current account of the balance of payments, could endogenously instigate the bust. This endogenous factor could be quite large if in addition, the central bank has systematically intervened in the foreign exchange market to limit the extent of real exchange rate appreciation, but failed to fully sterilize the monetary impact. Likewise, with open

capital account and internationally integrated domestic financial markets, an adverse exogenous event in the global financial markets could easily send contagion effects to the domestic financial markets, prompting the bust. In this regard financial markets can be a shock amplifier rather than an absorber. As to the extent of the bust, it would pretty much depend on the health of domestic financial institutions and the state of Government's long term fiscal posture. If the bust is accompanied by multiple failures of financial institutions and/or a deteriorating fiscal condition, then a deep and prolonged recession will ensue.

11. Again, the above adverse implications of large capital inflows cannot be mitigated by the standard monetary measure. In other words, a tightening of the policy rate to restrict credit condition may be a suboptimal measure for, *ceteris paribus*, it may prompt larger portfolio inflows and additionally would have across the board effects on the overall economy, not only on the bubble sectors.

12. Lower Middle Income Economies. The complexity of macro-policy environment in Lower MICs is somewhat different. Note that, typically, a lower MIC would be a factor driven economy. Those lower MICs that are rich in natural resources but have low capacity to innovate will attract FDI to the primary sectors for raw commodity and material exports, while those with less natural resources but endowed with ample supply of low cost labors will attract low cost manufacturing FDI, supplying both domestic and global markets. Lower MICs are also recipients of FDI tapping various project opportunities to develop the much needed public infrastructures. Short term portfolio flows are usually very limited as financial sector is still shallow, dominated mostly by Government owned banks and the non-bank sector is lacking adequate financial products and instruments for diversifying risks. In addition, given the absence of moderately deep and liquid financial markets, central banks in lower MICs mostly conduct monetary policy using quantity based instruments, or even a direct credit targeting.

13. With the above macro-policy environment, the standard policy advice for lower MICs would be to implement a consistent macroeconomic policy framework and expedite structural reforms to enhance economic efficiency and competitiveness. But this is easier said than done. Improved efficiency would depend on the implementation of a successful broad based economic reform to remove impediments to sustained economic growth and a stronger private investment. Moreover, as wages in lower middle income countries tend to increase overtime concomitant with the growing economic size, cross-cutting reforms are needed to start developing competitive edge based on knowledge, human capital, and innovation. This requires a multitude of Government interventions, including steps to improve access to market opportunities for the economically challenged households, which are still numerically numerous in lower MICs.

14. But to implement those more challenging and cross-cutting reform, lower MICs usually suffer from weak institutional capacity to plan, implement and monitor reform. This is more apparent if one examines the capacity at the operational echelons of the bureaucracy. As a result reform may progress quite slowly and at times loses momentum causing economic growth, job creation, and the rate of poverty reduction to decelerate. At this juncture it is tempting to substitute difficult reform with cyclical measures, particularly when (a) the real exchange rate appreciation tends to persist, causing domestic industries to lose nominal competitiveness, (b) the state of health of the banking industry is dubious, and (c) the state of long run fiscal posture is weak.

15. As a result the policy preference of macro-policy makers in lower MICs usually lean more towards demand side pump-priming policies, abandoning the target for internal balance and promoting a myopic cyclical expansion. Yet such preference would make lower MICs more prone to balance of payments and banking crises.

Addressing the challenge requires environment specific macro-financial policy mix

16. Some common recommendations. Having discussed above the diverse macro-financial policy environments in MICs, it is quite clear by now that the appropriate macro-financial policy mix for MICs may also vary depending on the policy circumstances. In short, there is no one size fits all cookie cutter advice on this matter. Nevertheless some common advices could be extended below.

17. First of all MICs have to ensure all banks (and also all non-bank financial institutions) are strong and healthy. It has been widely acknowledged that an economic crisis that includes a banking crisis will have a more severe and prolonged impact on the real side of the economy. An unhealthy banking industry also tends to weaken the determination of policy makers to implement a consistent macroeconomic policy (read: restrictive demand side policies) when these policies are most needed. As a result an unhealthy banking industry tends to exacerbate macroeconomic imbalances and solidify the foundations for a larger financial crisis. Accordingly, Governments in MICs need to develop stronger regulatory and supervisory frameworks for the banking industry and to continuously enhance the frameworks so as to make them in line with the international best practices. A further advice on this, which of late has been the subject of rigorous discussion in the financial policy circles, is to implement a counter-cyclical capital buffer. This would reduce the pro-cyclicality of credit growth over the business cycles, hence promoting moderation of economic cycles.

18. Second, MICs need to ensure Government's medium to long term fiscal posture is solid. A weak fiscal posture projects inconsistency of macroeconomic policy and a credibility gap which severely lowers the Government's ability to consolidate private supports for reform. Moreover, as the most recent global financial crisis has shown, bailing out a Government when it fails to honor its financial obligations is a grand-scale undertaking and very difficult to push through, vis a vis bailing out the private sector.

19. **Upper Middle Income Economies.** In addition to the above common recommendations, some specific policy recommendations could be put forward for upper and lower MICs. For upper MICs, it is important to manage the pace of further liberalization of the financial markets. While introducing more financial innovations into the financial markets will add to the vibrancy of trading activities and improve liquidity, this course of action would also increase the interconnectivity of domestic financial markets with the global financial markets, particularly with markets in mature economies, and attract more speculative traders. Macro-financial policy makers ought to carefully weigh in on the balance between advantages and disadvantages of such policy direction. Moreover, policy makers in upper MICs need to complement the implementation of stability oriented monetary policy with steps to further strengthen the regulatory, supervisory, and monitoring frameworks of the financial system. The overriding aim is to prevent excessive leveraging (risk taking behavior) that may compromise the state of financial stability . Works are still ongoing to

identify the best practices in this area of financial policy. But to err on the safe side, it suffices to say that the promotion of market discipline and injection of a good doze of conservatism through strong regulations are key factors in ensuring that financial markets do not develop into a shock amplifying factor for the real side of the economy and hence a nullifying factor on the pace of poverty reduction.

20. **Lower Middle Income Economies.** For the lower MICs, the first advice is quite standard, namely to implement a consistent macroeconomic policy framework with multiple instruments, including the traditional market based interest rate instrument and administrative measures such as statutory reserves requirement, for absorbing the excess liquidity generated by the capital inflows. This advice is particularly important for lower MICs at nascent stage of financial development. Toward that end it is important for lower MICs to enhance the development of domestic capital markets, with a particular attention to the market for Government bonds, by promoting a more liquid market for local currency Government bonds and a well-functioning money market. These would help increase the effectiveness of the implementation of a market based (indirect approach) of monetary policy. Next, as in the case of many emerging economies in the aftermath of the Asian financial crisis, lower MICs could also contemplate the use of fully sterilized foreign exchange market interventions, to limit the impact of real exchange rate appreciation on economic growth during episodes of large capital inflows. In other words, lower MICs might want to accumulate foreign exchange reserves and fortify themselves with self-insurance against the adverse impact of volatile capital flows. In this regard, many upper middle income countries have taken this route in the past. But if this measure is taken, in addition to full sterilization, lower MICs must also expedite real sector reform, for real competitiveness is an upshot of value added and not of prices. Last but not least, lower MICs should implement measures to strengthen the capacity of public institutions in planning, implementing and monitoring structural reform. This would help remove a large portion of impediments to a more balanced and higher long run economic growth.

## 2. Middle Income Countries and Financial Safety Net

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With the global economy recovering from the financial crisis, capital is flowing back to emerging market economies (EMEs). It is flowing mostly into middle income countries where the capital markets are relatively larger and more liberalized than those of less developed economies. Capital mobility allows countries with limited savings to attract financing for productive investment projects.

However, capital inflows may cause problems for the middle income economies.

It is worried that massive inflows can lead to exchange rate overshooting (or merely strong appreciations that significantly complicate economic management) or inflate asset price bubbles, which can amplify financial fragility and risk of crisis. Those concerns have grown stronger even though the flows are fundamentally sound. It is recognized that they may contribute to collateral damages, such as bubbles, asset booms and busts.

Another concern is on sudden reversal. Many of the capital flows are perceived to be temporary, reflecting interest rate differentials, which may be at least partially reversed when policy interest rates in advanced economies return to normal levels. Sometimes, sudden reversals cause financial crises because middle income countries usually do not have international convertible domestic currencies. Middle income countries might face insolvency problems, if the capital reversal increases fast and in great volume.

Middle income countries can take measures in two ways. Firstly, the countries may try to handle the surges in inflows that can pose both prudential and macroeconomic policy challenges. The tools include fiscal policy, monetary policy, exchange rate policy, foreign exchange market intervention, domestic prudential regulation, and capital controls. Clearly, the appropriate policy mix is likely to depend on the state of the economy, the level of reserves, the quality of existing prudential regulation, the scope to allow the capacity for the currency to strengthen, and the likelihood that the inflows persist etc.

Secondly, they need to establish fire walls against possible sudden reversal. During the financial crisis in 2008, many countries experienced the devastating impact of sudden reversals of capital outflows. They experienced liquidity shortages that could fundamentally endanger their economies. The fiscal crisis in the euro-zone has once again showed how swiftly an economic contagion may spread. The contagion effect is getting bigger, when the financial markets are more closely connected with each other.

Especially, the shortages of international liquidity threatened all the cross border economic activities of middle income countries. The MICs even faced insolvency problems. Moreover, financial crises have become increasingly contagious through interconnected international financial markets. For the MICs, the sudden reversal poses a much more serious threat, because the countries whose currency is not internationally convertible cannot be protected by lender of last resort. International monetary architecture lacks the function of lender of last resort.

International community has recognized the lack of international lender of last resort as a serious threat which can lead to another crisis to the global economy in the future. The G20 established the

FSN experts group to solve this problem in 2010 before the Seoul Summit. The experts group assessed at first the ability of the current global financial architecture to deal with the economic and financial shocks resulting from capital flow volatility. They reached the following conclusions:

First, countries need to rely on external mechanisms when faced with a crisis, while the first line of defense such as sound economic policies, prudential management or self-insurance is effective in cushioning the shocks of capital volatility.

Second, the current financial safety nets such as the FCL (Flexible Credit Line) and bilateral currency swap arrangements have limitations even if they played a crucial role as a firebreak”.

The experts group suggested some additional options to strengthen the global financial safety nets. The first option was to enhance the effectiveness of the FCL and to develop other FCL-like instruments, such as the PCL(Precautionary Credit Line). IMF introduced the PCL following the recommendation of the expert group in 2010 and the PCL developed into PLL in 2011 after the G20 summit in Cannes.

The second option suggested by the experts group was to institutionalize bilateral swap lines among central banks as well as the multilateral swap lines. However, bilateral swap lines are left to the individual countries due to the differences in political interests among countries. The CMIM, Asia’s multi-country swap line, has improved its institutional weaknesses by establishing regional surveillance mechanism.

The third option was to enhance co-operation between the IFIs and regional financial safety nets. This suggestion has been materialized in the managing process of euro-zone crisis.

Even though the global community has expanded the financial safety net in many ways, the global FSN does not seem to be enough to guarantee financial stability. The MICs have accumulated much more foreign exchange reserves since the 2008 global financial crisis. Only three countries have taken use of IMF’s FCL, and for PCL, just one. This implies that the individual countries still rely more on their own reserve stock rather than on the international FSN.

MICs find themselves exposed to the risks caused by capital in-and outflows. The incomplete financial safety nets should be complemented and improved continuously. Therefore, MICs should take the initiatives in making globally coordinated efforts more vigorously to address this important issue. With regard to establishing global financial safety nets, the financial policymakers should, when assessing potential policy options, pay attention to a set of principles suggested by the G20 FSN experts group. They are as follows:

First, certainty: countries have to be assured of accessibility when they are in need;

Second, sufficiency: the amount available has to be enough to cover problems;

Third, stigma-free: eliminating or reducing the stigma effect is very important to enable countries in need to access the resource;

Fourth, minimizing moral hazard: the options should be based on sound incentives.

## V. Climate Change and Green Growth

### 1. Climate Change and Green Growth with focus on Gender and Climate Change

**Dr Agnes A. Babugura**

Professor, Monash University South Africa

#### Introduction

Though scientific evidence has shown that the world is warming, a large amount of uncertainty regarding the scope, timing, and the magnitude of future climate change remains. There is a possibility that scientists may never be able to predict accurately the frequencies of climatic events. Regardless of these uncertainties, there is no doubt that climate is changing. It is predicted that climate change is likely to worsen the impacts of current climatic events that have already been highlighted by events such as droughts and floods (IPCC 2007). These impacts have serious consequences for green growth.

Already experienced climatic events as well as the impacts (e.g. reduced crop yields, livestock losses, water shortages, hunger and loss of human life) provides very useful analogy for thinking about the future and an effective path way for green growth, given that they are not hypothetical, but are already real and known. Existing evidence suggests that climate change exacerbates existing development challenges, further exposing the vulnerability of the societies (IPCC, 2001). It has also been established that the impacts of climate change will not be equally distributed but rather differentiated across regions, generations, age classes, income groups, occupations and between women and men. This is attributed to various factors (social, economic, and political) that may affect their ability to anticipate, prepare for and respond to climate change. This presentation focuses specifically on the gender aspects of climate change.

At this point it is important to clarify some of the gender concepts used in the presentation. **Gender** is not interchangeably with women but that it refers to both men and women as well as the relations between them. It refers to the different roles and identities that we are given depending on whether we are male or female. The **gender roles** are usually influenced by culture, institutions such as the family, education, religion, the economy, the state and laws. They refer to social norms of behaviour, values, and attitudes that are deemed appropriate for men and women and the relations between them. The different gender roles we play are not fixed at birth and are what we all learn and finally choose. **Gender Equality is often perceived to mean that** women and men will become the same. This is not the case, **it** refers to women and men having equal conditions for realizing their full human rights and for contributing to, and benefiting from, economic, social, cultural and political development. It's about achieving equitable influence on establishing development priorities and outcomes for women and men. It involves ensuring that the perceptions, interests, needs and priorities of men and women are given equal weight in planning and decision making.

## Gender and Climate Change

Having recognized that climate change is a major human security issue that poses serious global threat, addressing its threats has become a global priority. In the context of the significant attention given to climate change, debates regarding identification of gender perspectives and the involvement of women in addressing climate change have arisen. It is believed that men and women are impacted differently by climate change, hence the differentiated vulnerabilities and response mechanisms. This is attributed to existing inequalities such as, their role and position in society, access to resources and power relations that may affect the ability to respond to the effects of climate change.

The impacts of current climatic events such as the loss of human lives and livelihoods, destruction of economic and social infrastructure, as well as environmental damages have already highlighted differential impacts between men and women. Debates on gender differentiated impacts of climate change have therefore led to recognition that there is a need to mainstream gender into the climate change policies, with the hope of enabling effective policies and actions that will benefit both men and women. This would also promote gender equality, opening up opportunities especially for women to participate in decision making. It also contributes to knowledge concerning interrelations between climate change and gender, as well as bringing women and men's experiences and interest to the limelight.

Efforts to address gender inequalities are not new, they can be traced back to 1945, when the United Nations Charter acknowledged the need to respect human rights and fundamental freedoms for all without distinction as to... sex (see Charter of the United Nations). Since then, several initiatives to address gender inequalities at global, regional and national level have been developed. These initiatives for example include, the Convention on the Elimination of All Forms of Discrimination Against Women (CEDAW), the Dakar and Beijing Platforms for Action (BPFA), the UN System-wide Policy on Gender Equality and the Empowerment of Women, The Human Development Paradigm, The Millennium Development Goals (MDGs), and several other national policies and frameworks for women's empowerment and gender equality. It is through such initiatives that a significant stride towards the achievement of gender equality can be acknowledged.

These efforts not only highlight the relevance and importance of promoting gender equality but also acknowledge that equality between men and women is a matter of human rights and social justice. It is a precondition for sustainable development, climate change adaptation, mitigation and a foundation of democracy. The perceptions, interests, needs and priorities of both men and women must be taken into consideration not only as a matter of social justice but because they are important and necessary to enrich development processes. Be it at international, regional, national or local level.

Despite the efforts made thus far, research has shown that in practice it is often more challenging for women to access and exercise their rights. Policies, institutions and governance systems often fail to address issues of gender and related inequalities that play a major role in building men and women's resilience to climate change. Disappointingly, decades after the United Nations Charter calling for the respect human rights, the first United Nations World Conference on Women in Mexico City, and years after the ratification of the various gender equality treaties, women remain grievously under-represented in decision making processes.

In the context of climate change debates, an overall assessment to date shows that women are absent in the decision-making process. Their contribution to climate changes policies is largely

ignored. Decision-making and policy formulation are predominantly male agendas. The climate change debate is an indicator of how gender issues tend to be omitted, resulting in climate change policies and interventions that are gender blind. This has implications for effective climate change adaptation and mitigation. There remains a great need for integrated climate change policies that empower women and men to exercise their full potential to contribute towards climate change interventions.

This is not to say all efforts have been in vain. There have been some positive results leading to the recognition of the importance of gender equality in all spheres of development. For example, the active participation of women in the Rio Earth Summit resulted in obtaining a chapter (24) on women and sustainable development and over one hundred references and recommendations pertaining to women in the final agreement, Agenda 21. The agreement proposed actions to strengthen women's role in sustainable development by eliminating obstacles that hinder their equal participation, particularly in decision making.

Women's caucuses since COP-11 in 2005 have also strongly lobbied for a gender approach in all critical areas of climate change. Prior to the UN Climate Change Conference held in 2007 in Bali, representatives of the International Union for the Conservation of Nature (IUCN), the United Nations Development Programme (UNDP), the United Nations Environment Programme (UNEP), and the Women's Environment and Development Organization (WEDO), came together to address the emerging issue of gender and climate change. These institutions recognized that global policies and strategies on climate change did not yet incorporate a gender perspective and agreed on the need for a coordinated strategy. The result was the formation of the Global Gender and Climate Alliance (GGCA), which was publicly launched at the 13<sup>th</sup> Conference of the Parties (COP) held in Bali.

The GGCA which has grown to include over 50 member organizations, including UN agencies, Inter-governmental Organizations (IGOs), and civil society organizations (CSOs), has built a track record for concrete action on gender and climate change in the areas of policy, finance, and capacity-building on the national, regional, and global level. These activities have contributed to the recognition of the gender implications of climate change in UN processes among governments, and in civil society activities.

Unprecedented gains were made at COP-17 in Durban, South Africa. Through a series of advocacy and capacity development activities, UNDP and partners in the GGCA succeeded in having 18 gender references integrated throughout the final text. In the area of finance, efforts are underway to ensure gender considerations are incorporated into climate financing. For example UNDP is working with fund boards and secretariats to advocate for the integration of gender dimensions into operational frameworks and decision-making.

Among the major challenges hindering efforts to support and promote the integration of gender in climate change initiatives, is the lack of expertise on gender and climate change and poor understanding of why gender matters. In order to appreciate why gender matters, there is a need to understand the gender dimensions of climate change. Understand different adaptive strategies men and women apply in order to secure their livelihoods in the face of climate change. This enables climate change interventions to appropriately target men and women. It allows policymakers, development practitioners and researchers to see how marginalized groups, could gain equitable access to and use information resources that would allow them to make better decisions on how to adapt to climate change.

Successful gender mainstreaming (see box below) in climate change mitigation and adaptation activities will require capacity development at all levels to establish a good foundation. To facilitate this process and the work of regional and national development practitioners, policy makers,

governments and other partners, UNDP and partners have also recently developed a Series of thematic policy briefs and training modules on gender and climate change on issues including gender and climate change overview, adaptation, agriculture and food security, equitable energy access and climate finance.

Gender mainstreaming has been an essential part of equal opportunities policy worldwide, since the UN's Fourth World Conference on Women in Beijing in 1995. Gender mainstreaming is seen as a process that unfolds within the social context of a country or region therefore takes many different forms. (Ministry of Foreign Affairs, Foreign Information and Communication, 2002). Regardless of the different forms it may take, its ultimate goal is to achieve gender equality. Within the United Nations system, gender mainstreaming is generally defined as follows;

*"... the process of assessing the implications for women and men of any planned action, including legislation, policies or programmes, in all areas and at all levels. It is a strategy for making women's as well as men's concerns and experiences an integral dimension of the design, implementation, monitoring and evaluation of policies and programmes in all political, economic and societal spheres so that women and men benefit equally and inequality is not perpetuated. The ultimate goal is to achieve gender equality." (United Nations, 2002 pg 1)*

## Conclusion

If climate change is to be effectively addressed in the context of green growth then interventions and policies must ensure a greater social premise from a gender perspective. Much work remains to be done and therefore the various commitments and action plans made over the years through international, regional and national forums need to be honoured. Gender equality should define the path way for climate change adaptation and mitigation in the context of green growth.

## 2. Shared Challenges to Middle-Income Countries and the Korean Development Experience, With focus on Climate Change and Green Growth and Urbanization with/for Growth

**Okju Jeong**

Senior Program Manager, Global Green Growth Institute (GGGI)

### Climate Change and Green Growth: Common Challenges and Opportunities for All

“Climate Change” and “Green Growth” are more than environmental protection, broader and evolving concept built on “Sustainable Development”

- Green Growth is “a new economic paradigm”, “economic growth with environmental sustainability”, “a low carbon climate resilient development pathway”
- “Green Growth means fostering economic growth and development while ensuring that natural assets continue to provide the resources and environmental services on which our well-being relies”; “Green Growth should be considered a subset of it. It is narrower in scope, entailing an operational policy agenda that can help achieve concrete, measurable progress at the interface between the economy and the environment”(OECD, 2011, Towards Green Growth).
- “Green Growth is thus a practical attempt through economic policy to operationalize the normative frameworks represented by the sustainable development and green economy concepts”(GGGI Issue Paper, 2013, Green Growth and the Post-2015 Development Agenda)

**Green Growth is not the preserve of upper-middle income countries and/or above, but relevant and crucial for all categories of countries from underdeveloped to developed countries**

- **Global Green Growth Institute(GGGI)** provides analytical and institutional support to more than 20 emerging and developing countries who wish to develop green growth, which are aligned with other national economic goals (28 Projects in 17 Countries & 4 Regions, as of February 2013)
- Many emerging and developing countries recognize the importance of climate change; and develop national green growth strategy and its action plan to incorporate climate change programmes and projects for transitioning to a low carbon climate resilient development pathway
- Some Examples of national green growth plans

**National Strategic Plan on Green Growth & National Council on Green Growth (NCGG) in Cambodia (2013)**

The Cambodian Government developed the National Strategic Plan on Green Growth with a particular focus on efficient use of natural resources, green jobs, green technology, and economic reforms with a strong emphasis on green taxation.

### **Ethiopia's Vision for a Climate Resilient Green Economy (2011)**

“Ethiopia did not cause climate change, but we are confronted by the threat that it poses, and should recognize the opportunity that it presents. Climate change is not a future possibility for Ethiopia, it is a present reality. That is why it is imperative that we start now protect our people and our environment, while at the same time building a green economy that will help to realize the ambitions set out in the Growth and Transformation Plan”

### **Vietnam National Green Growth Strategy (2012)**

“Green Growth, as a means to achieve a low carbon economy and to enrich natural capital, will become the principal direction in sustainable economic development; reduction of greenhouse gas emissions and increased capability to absorb greenhouse gas are gradually becoming compulsory and important indicators in socio-economic development”

### **Kenya's Climate Change Action Plan: Low Carbon Climate Resilient Development Pathway (2012)**

“A low carbon climate resilient development pathway, as set out in this Climate Change Action Plan, can help meet Vision 2030 goals through actions that address both sustainable development and climate change. This pathway can also help the government achieve the Millennium Development Goals and other internationally agreed development goals without compromising the environment and its natural resources”

### **Facilitating Green Growth in Africa (AfDB, 2012)**

“RIO+20 underscored that Green Growth and the transition towards green economy is considered by a growing number of African and developing countries a viable and necessary approach to development. Several African countries have taken the lead in defining their strategic approach to green growth and launching their road maps towards a green economy”

“For Africa, the priority is to develop. Promoting green growth in Africa means addressing existing and emerging development challenges without locking countries into development pathways that deplete Africa's natural capital and leave economies and livelihoods more vulnerable to climate change and other environmental, social and economic risks”

**Urbanization with/for Growth:** More Highlight on the Korean Spatial policy to influence Demographic and Economic Geography of the Country

**Urbanization matters for growth:** Geographic aspects of the demographic transformation have to be more distinctively shed light on, as the demographic transition coincides with a spatial transformation

- Cities are the hubs of economic activity accounting for some 70% of global GDP
- How to harness urban development for better allocation of limited resources through different spatial and economic measures? The governments try to influence the pace or location of urbanization through a series of spatial policies and plans (Comprehensive National Territorial Plans can be a good example, for Korean case)
- Urban diseconomy when cities are not well managed. Corrective measures are required, for example, mitigation of over-concentration in the Capital city and metropolitan cities, promotion of secondary cities as poles of growth across the country

**Urbanization causes growth or growth causes urbanization?**

- “We know of no countries that either achieved high incomes or rapid growth without substantial urbanization, often quite rapid. There is a robust relationship between urbanization and per capita income: nearly all countries become at least 50 percent urbanized before reaching middle-income status, and all high-income countries are 70-80 percent urbanized” (World Bank, 2009, Urbanization and Growth)
- Urbanization and growth do not always go together. An increase in the size of the urban population has not necessarily been associated with growth, especially in Africa urbanization, accompanied by very low growth, is concentrating poor people in cities rather than the countryside



**Global  
Partnership**  
for Effective Development  
Co-operation

# Busan Global Partnership Workshop

Implementation strategies  
for effective development co-operation  
at country level

Middle-Income Countries Sessions



외교부  
Ministry of Foreign Affairs



Empowered lives.  
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## Busan Global Partnership Workshop

### Implementation strategies for effective development co-operation at country level Middle-Income Countries Sessions

#### I. Concept Note

##### Overview

On 18-19 November 2013 in Seoul, the Ministry of Foreign Affairs of the Republic of Korea and UNDP Seoul Policy Centre for Global Development organized a two-day Busan Global Partnership Workshop on 'Implementation strategies for effective development co-operation at country level'.

The event focused on country-level implementation of the Global Partnership for Effective Development Co-operation. Complementing the evidence generated through the global monitoring process, it provides an opportunity to deepen the substantive components of the agenda and thematic sessions for the first High Level Meeting of the Global Partnership that will be held in Mexico in April 2014. It is also expected to help forge key messages to be taken to the High Level Meeting.

Policy-makers and practitioners from other 30 countries and experts from business, international organizations and civil society considered (1) Policies, strategies and measures put in place by developing countries to implement the Global Partnership, (2) key challenges encountered by countries to advance effective development cooperation and policy coherence for development and (3) key deliverables and messages to feed into the thematic sessions of the ministerial-level meeting

The discussion considered how effective development co-operation might feature in a post-2015 development framework and what, in concrete terms, the Global Partnership can bring to implement the post-2015 agenda. The Workshop marked a major milestone on the road to the upcoming meeting in Mexico.

##### Global Partnership and middle-income countries

In the run up for Mexico's Ministerial-level meeting, emphasis has been put on the MIC categorization. MICs category is too wide and heterogeneous, and the income per capita definition an ineffective measurement to address development challenges.

As a response to this debate, the workshop addressed the MICs issue in two sessions of its agenda:

- **Emerging Issues toward the Ministerial Meeting** - Jonathan Glennie (ODI), provided a presentation and a background paper 'The "Middle Income" conundrum: The need for and effectiveness of international assistance in "Middle Income" countries' .
- **Global Partnership and its implication on MICs** - Chaired by Gerardo Bracho (Mexico, OECD-DAC), the session was designed to provide key messages on the MICs issue toward the Ministerial meeting .

This chapter presents the key documents of these sessions.



## II. The “Middle Income” conundrum: The need for and effectiveness of international assistance in “Middle Income” countries<sup>23</sup>

*Jonathan Glennie*

Independent writer and consultant, a Research Associate (formerly Senior Research Fellow) with the Overseas Development Institute, and a Guardian columnist.

*DRAFT, SUBJECT TO FURTHER REVIEW; COMMENTS WELCOME*

**Abstract:** This background paper responds to specific questions as to the usefulness of the Middle Income country (MIC) category for aid allocation and effectiveness. It is in two parts. First, I argue that an objective needs analysis, as opposed to a prioritising exercise, would show the need for high levels of foreign assistance in most MICs, given continuing poverty and structural transformation requirements, made even more expensive by local and global environmental considerations. Second, I show that classifying countries by aid-receipt rather than income/capita provides a useful way in to analysing the role and effectiveness of aid in MICs. The vast majority of the world’s poorest people have long lived in countries where aid is a very small part of the economy (Very Low Aid and Low Aid countries). Aid plays a different role depending on its size relative to the economy, and effectiveness debates should reflect that.

### *Note on terminology*

I use the term “aid” here to refer broadly to international public finance flows, not just Official Development Assistance (ODA) as defined by the OECD. However, the statistics are for ODA – other sources are not yet good enough to introduce.

### *Contents*

1. Need. What is the role of the international community in supporting MICs?
2. Effectiveness. Should we be talking about MICs or LACs?
3. Conclusion

<sup>23</sup>Background paper prepared for the Seoul International Workshop of the Global Partnership of the Effective Development Co-operation, Seoul, Korea, 18-19 November 2013

## 1. Need. What is the role of the international community in supporting MICs?

**“There is basically no role for international development cooperation in middle income countries.”**

*Paul Collier, author of “The Bottom Billion”*

As economies grow the role and relative importance of international public finance evolves. If growth is relatively balanced household incomes will improve and domestic revenue collection will likely increase. Meanwhile private investment from abroad will be attracted by better opportunities and improving infrastructure.

This correct generalisation has led the international community to a point whereby when countries pass a certain income/capita threshold it is assumed official foreign assistance should decline over time and eventually end entirely. Countries described as “middle income”, it is argued, no longer need such support.

However, this assessment of need is flawed. International public financial flows, and development cooperation more broadly, remain an important complement to domestic and foreign private sources of development finance to help respond to a) the very high levels of material poverty which remain in many MICs and b) the investments in infrastructure and structural transformation to embed progress, especially if such progress is to be environmentally sustainable. Prioritising scarce resources towards the very poorest countries should not be mistaken for needs analysis of slightly wealthier ones.

### **Poverty**

**“The idea that South Sudan is a Middle Income country is a joke.”**

*Tisa Sabuni Aggrey, Economic Advisor to the President of the*

*Republic of South Sudan<sup>24</sup>.*

The actual words “Middle Income” are proving unhelpful in communicating development realities to busy lawmakers, journalists and the public at large (see Glennie 2013). They imply that such countries are no longer poor, but this is true only if we draw an unacceptably low bar for poverty. For example:

- Guatemala, an established Middle Income country, has the third-highest rate of chronic malnutrition in the world, at 54%.

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<sup>24</sup> Now Minister of Finance and Economic Planning. Remarks on hearing that South Sudan was so classified, at the CAPE Conference, November 2012, London. <http://www.odi.org.uk/events/2972-aid-development-cooperation-cape>

- More than one third of the world's malnourished children live in India, where prevalence is double that of sub-Saharan Africa. India has been a Middle Income country since 2007.
- Meanwhile South Sudan emerged onto the international scene as a Middle Income country in 2011, despite facing grave poverty. In 2012 it was Low Income again, as oil exports fell.

Some make the case that these countries have the means to deal with poverty, if they were only to allocate resources better, and it is true that there is inequality is severe in many MICs. But there are two problems with this argument.

First, the international development community is in danger of placing too much stall with an exaggeratedly stingy definition of poverty, intended to identify the most destitute people on the planet not to stipulate an acceptable standard of living. Even if MICs had the wherewithal to deal with \$1.25/day poverty, thresholds nearer \$5 or \$10/day would better imply resilience against the possibility of falling back into extreme destitution (Sumner, 2013).

Second, the political feasibility of redistributing wealth and income is over-estimated in such scenarios. India, for example, like many developing countries (whether Low or Middle Income) has a Gini coefficient on a par with most developed countries (and significantly below that of the United States); while desirable, there is no reason to expect radical redistribution.

In some instances international interference, especially in the form of financial assistance, may lessen political pressure for pro-poor changes. But as aid diminishes as a proportion of the economy, it is less likely to dissuade redistributive measures (it is not big enough to have such an effect) but could promote such measures, through good example and targeted interventions (see next section where we discuss aid in Low Aid Countries) i.e. it is too context-specific a concern for generalisations.

### *Sustainability*

**“Development only really begins when extreme poverty is eradicated.”**

*Adolf Kloke-Lesch, former managing director at GIZ, Germany*

Despite the important focus of the international community on the poorest and most marginalised communities, there is more to development than poverty reduction. Continued economic growth and indeed structural transformation (i.e. moving beyond agriculture and resource extraction towards manufacturing and technological innovation) will be required for countries to maintain spending on infrastructure, social investments and other public goods. This has long been recognised by foreign assistance programmes – the tight focus on direct-targeting of poverty only became conventional in the 1990s.

A number of countries have expressed concern that passing an arbitrary income/capita line has jeopardised their ability to access international public finance despite the fact that they are still

unable to access significant amounts of private capital because their economies are still developing<sup>25</sup>.

Estimates for infrastructure needs in developing countries are huge, with one study suggesting that “the incremental investment spending across emerging markets and developing countries is estimated at around \$1 trillion a year more than what is currently spent”, with electricity, water and transport accounting for the bulk of this (Bhattacharya et al, 2012). Most of this spending will, inevitably, take place in MICs and while much of this money will be raised domestically or from the private markets, international public finance will continue to have an important role to play, given its particular qualities.

The need for continued support for structural transformation is even greater in a world in which sustainable development is becoming vital for global survival, with a heavier burden of responsibility on already industrialised countries. In fact, the need for “green” rather than dirty growth has changed the game on the need for international public funds. If industrialised countries are serious about asking poorer countries to keep global CO2 emissions to a minimum, in a context where they are struggling to reduce their own emissions, they will need to pay other countries for this costly environmental service, a principle established in the COP meetings on climate change.

These investments will not all fall into the ODA category, and increasingly the line between private and public financing is blurred in the international realm. The point here is not the precise modalities of international public funding for sustainable development, but the principle that need is *increasing* rather than reducing.

But there is no point in spending scarce public resources, even where there is need, if they don’t have an important effect for poverty reduction and sustainable development. Is aid effective in MICs, and how can it be more so? It is to this question that we now turn, introducing the concept of Low/Middle/High Aid Countries to the lexicon.

## 2. Effectiveness. Should we be talking about MICs or LACs?

**“The main client base for the Paris Agenda’s stipulations on aid effectiveness was stable lowincome countries”.**

*OECD policy adviser, quoted in Glennie et al, 2013*

The question “how can aid be more effective in MICs” is not obviously one that has a logical answer, there being so many types of aid and so many types of MIC – 103 of the 139 countries conventionally described as “developing”. The one characteristic binding MICs – a per capita income of over about \$1000 – may not be a very relevant one for making aid decisions.

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<sup>25</sup> For example, Cape Verde’s Minister of Finance gave a speech expressing this concern at the UN Development Cooperation Forum’s Switzerland High-Level Symposium in Montreux, 24-25 October 2013

One lens through which to view this problem is the amount of aid a country receives, relative to the size of its economy. In a paper last year Annalisa Prizzon and I categorised countries by their level of aid receipt. Table 1 shows the four categories we settled on (Glennie and Prizzon, 2012).

**Table 1: Categorising countries by aid receipt**

Country classification	Aid/GNI (%)
<b>Very Low Aid countries (VLAC)</b>	Under 1%
<b>Low Aid countries (LAC)</b>	1.00-1.99%
<b>Middle Aid countries (MAC)</b>	2.00-9.99%
<b>High Aid countries (HAC)</b>	Over 10%

*Source: Glennie and Prizzon, 2012. We explain the reasoning behind these cut-off points in the paper.*

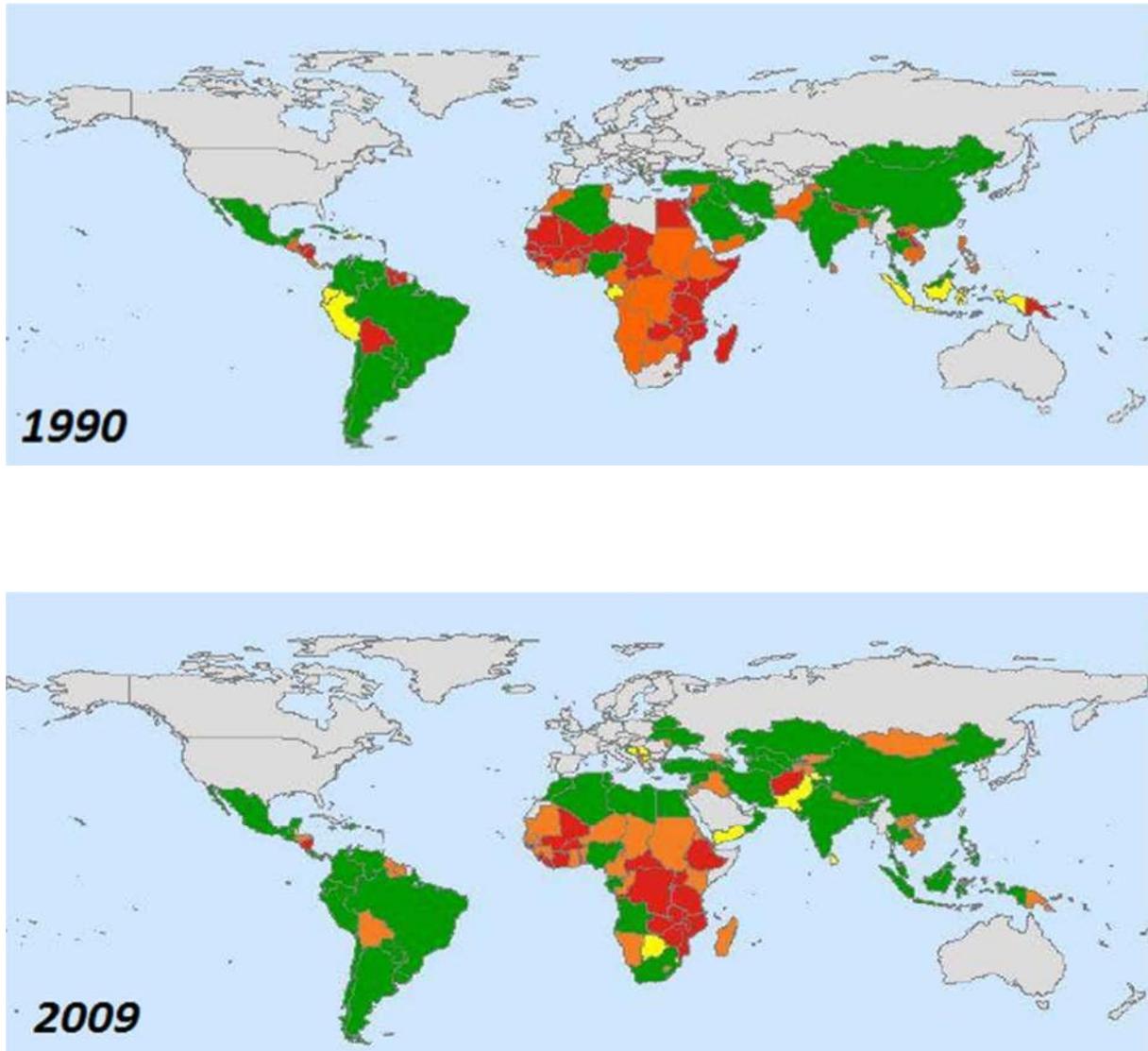
### *Getting to Low Aid*

We argue that as countries are increasingly vocal about their ambitions to reduce aid they should not aim to end it entirely, but to get into the green zone of Very Low Aid, or at least the yellow zone of Low Aid, noting that it is aid dependency rather than aid itself that is problematic. This allows the possibility that as recipient economies grow, aid receipts can continue to increase while aid dependency itself (i.e. aid/GNI) reduces to a more sustainable and healthy level. This is precisely the scenario that may be required in the present era, as needs in MICs continue to expand, and aid becomes a smaller but still important intervention.

As countries higher up the income/capita scale are, on average, less dependent on aid, in country classification terms MICs are more likely to be Very Low Aid countries (VLACs) and Low Aid countries (LACs). As many economies have grown fairly well in the last two decades, the number of High Aid countries (HACs) has reduced, and the number of VLACs has increased. This is shown in the maps in Figure 1 below – there are more green countries in 2009 than in 1990<sup>26</sup>.

<sup>26</sup> I have not been able to update this data for this background paper, so I use the data from our 2012 publication, which included aid data until 2009.

**Figure 1: Mapping countries by aid receipt: 1990 and 2009**



Source: Glennie and Prizzon, 2012.

But what is remarkable for the purposes of the present study is just how many green VLACs there *already were* in 1990. These are countries that have never been aid dependent, or certainly not for several decades, but in which aid has played a very small role (in terms of quantity) in the economy. There are two categories of these long term VLACs worth looking at: longtermMICs and verylargenewMICs.

Table 2 shows a selection of Latin American long-term MICs (i.e. as opposed to the newer MICs of the last couple of decades)<sup>27</sup>. All but the last six countries on this list (three Central American countries and three small island states) and Jamaica (whose

trajectory appears somewhat exceptional) have been LACs or VLACs since at least the 1980s i.e. they have received varying, but always Low or Very Low, levels of aid. Such countries are not

<sup>27</sup> Data in Tables 2 and 3 is for average aid/GNI over a ten year period.

reducing their dependence on aid – they could never be described as having been dependent – but are maintaining a non-dependent use of aid, presumably to support specific development interventions.

**Table 2: Aid receipt classification of Latin America’s long term MICs**

Country	1980s	1990s	2000s
Mexico	0.06	0.05	0.02
Brazil	0.04	0.03	0.03
Venezuela, RB	0.05	0.06	0.05
Argentina	0.07	0.07	0.06
Chile	0.14	0.17	0.08
Panama	0.69	0.55	0.08
Costa Rica	1.74	0.54	0.12
Uruguay	0.24	0.25	0.13
Dominican Republic	1.06	0.50	0.34
Jamaica	3.10	1.37	0.38
Colombia	0.31	0.35	0.48
Peru	1.09	0.88	0.65
Ecuador	1.13	1.05	0.67
Paraguay	1.26	1.13	0.82
Antigua and Barbuda	1.72	1.05	0.96
El Salvador	4.56	2.71	1.22
Guatemala	1.56	1.50	1.25
Belize	4.96	3.24	1.72
St. Lucia	4.23	3.61	1.81
St. Kitts and Nevis	4.63	3.10	2.71
St. Vincent and the Grenadines	6.87	5.62	3.36

*Source: Author’s calculations, using data from World Development Indicators*

There are also long term LACs and VLACs in Asia (such as Malaysia and Iran) and Africa (South Africa and Algeria) which offer an insight into how foreign financial assistance can be useful at low levels over prolonged periods. It is not clear what has changed in recent years that would make such interventions less useful.

The second set of interesting countries is very large new MICs. Table 3, below, presents all the newly graduated MICs in ascending order of aid/GNI. This group is varied in character, with a preponderance of High and Middle Aid countries. These countries have seen fluctuating average aid levels in recent decades, but broadly speaking, and with notable exceptions such as Ghana and the Solomon Islands, the data supports the notion that as countries progressed to MIC status after the turn of the century their aid dependence has decreased.

**Table 3: Aid receipt classification of the newly-graduated MICs**

Country	1980s	1990s	2000s	Year of graduation
China	0.35	0.46	0.08	1999
India	0.81	0.59	0.21	2007
Ukraine	n/a	0.00	0.40	2002
Indonesia	1.22	1.16	0.61	2003
Turkmenistan	0.00	0.91	0.69	2000
Nigeria	0.33	0.84	0.73	2008
Uzbekistan	0.00	0.67	1.36	2009
Pakistan	2.86	1.93	1.65	2008
Azerbaijan	n/a	3.52	2.67	2003
Cote d'Ivoire	2.59	8.77	2.68	2008
Yemen, Rep.	n/a	5.84	2.73	2009
Angola	2.02	8.70	2.86	2004
Vietnam	1.97	4.03	3.97	2009
Sudan	7.21	4.35	4.16	2007
Cameroon	2.70	6.62	5.67	2005
Lesotho	14.48	9.67	5.82	2005
Georgia	n/a	5.09	6.12	2003
Moldova	n/a	4.88	6.22	2005
Armenia	n/a	9.99	6.81	2002
Congo, Rep.	4.90	11.97	6.99	2005
Senegal	12.14	11.88	8.89	2009
Ghana	6.32	9.86	11.21	2011
Bhutan	13.61	20.95	11.41	2006
Mongolia	0.13	17.45	12.62	2007
Lao PDR	11.08	17.14	12.74	2011
Mauritania	25.41	18.85	15.73	2011
Zambia	13.59	26.46	17.20	2011
Nicaragua	8.43	30.73	17.89	2005
Sao Tome and Principe	n/a	n/a	24.43	2008
Solomon Islands	24.35	14.64	29.78	2008
Timor-Leste	n/a	n/a	42.37	2007

Source: Author's calculations, using data from World Development Indicators

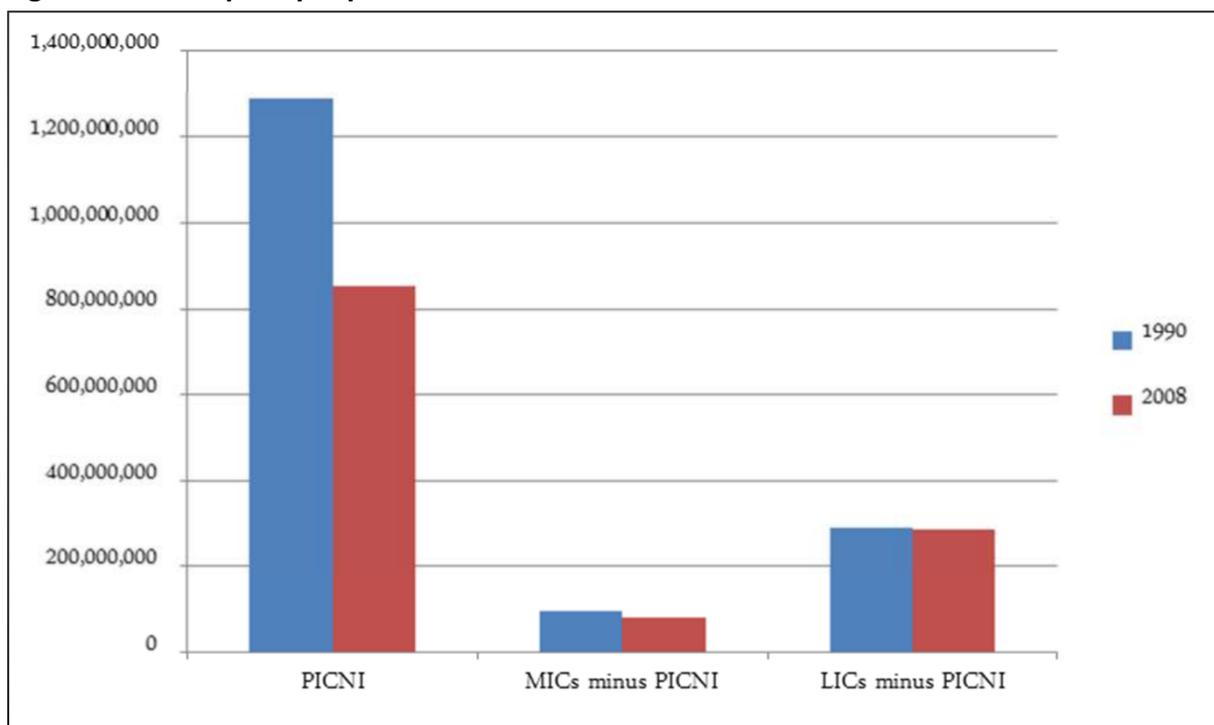
However, what about the VLACs and LACs, the first seven countries in Table 3? While aid levels have also decreased in most of them, this cannot be described as a reduction in aid *dependence* because, like the long term MICs in Latin America, they have never been aid dependent. Rather, they have handled low levels of aid for at least the past three decades. It is not clear

what the consequences the “graduation” of these long term LACs and VLACs should be. If aid in small quantities (relative to the size of the economy) has been useful until now, why should it not continue to be so?

*Where do poor people live?*

These countries are also key to understanding the data on the changing location of poor people. It is well known, thanks to Andy Sumner’s important research, that while only about 7% of the world’s poorest people lived in MICs in 1990, that figure had reached about 75% in 2008, the “new bottom billion” (Sumner, 2010). However, using the VLAC/LAC/MAC/HAC approach we can avoid drawing the wrong implication from this ubiquitous statistic. As we saw in Table 3 above, among the “graduates” to MIC status during that period were five of the world’s six or seven most poor-populous countries: India (home to about 480m poor people today), China (c. 200m), Nigeria (c. 100m), Indonesia (c. 45m), and Pakistan (c. 40m)<sup>28</sup>. These account for the entirety of the shift of poor people from LICs to MICs, as Sumner himself acknowledges. If we remove these “PICNI” countries from the equation, we see that there has been no shift whatsoever in the whereabouts of poor people – the same proportion live in MICs now as did two decades ago – see Figure 2.

**Figure 2: Where poor people live – the PICNI effect**



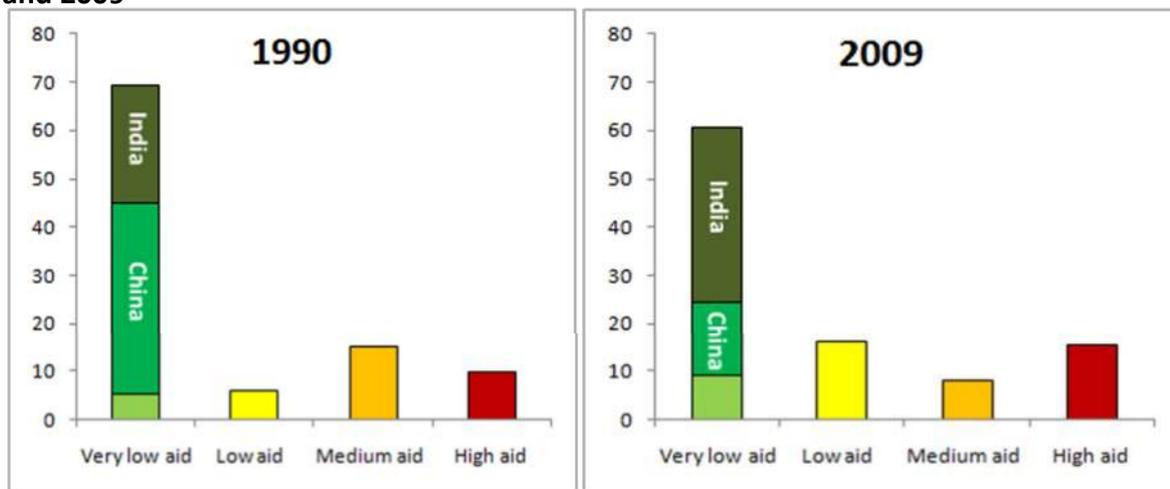
Source: Author’s calculations, using data from World Development Indicators

While the poor people and MICs analysis has helped frame our understanding of the present development era, it might be something a red herring with regard to aid decisions. Again, however, aid-receipt classification can shed light on this debate. Figure 3 shows the proportion of poor

<sup>28</sup> Bangladesh is also in the top six, with around 75mn poor people, and is still a LIC. DR Congo has about the same number of poor people as Pakistan.

people living in different aid-receipt classifications in 1990 and 2009. Around 75% of the poorest people lived in VLACs or LACs in 2009. However, because the vast majority of these live in India and China, this is almost *exactly the same proportion* as in 1990. In other words, the vast majority of the world's poorest people have *for some decades* lived in countries where aid is a minimal part of the national economy (Glennie, 2012). We return, therefore, to the same question – what has changed today to imply that small amounts of aid can no longer play a useful role in these countries?

**Figure 3: Proportion of \$1/day poor living in different country classifications, 1990 and 2009**



Source: Glennie, 2012

### *Improving aid effectiveness in (Very) Low Aid countries*

“What is relevant is not so much the direct effect of the amount of resources channelled by aid, but the role that international cooperation may play in modifying the framework of incentives in which agents operate.”

*Jose Antonio Alonso, Professor of Applied  
Economics at Universidad  
Complutense of Madrid*

To answer the question about aid effectiveness in (Very) Low Aid countries we need first to understand the role aid plays in them, and how it may differ significantly from its role in Middle and High Aid countries. In brief, while in MACs and HACs aid fills financing gaps, in LACs and VLACs it is far more likely to play a role incentivising particular behaviours (Alonso 2007).

The Paris Agenda, the most complete attempt to improve aid effectiveness in modern times, was not written with a view to the needs of (V)LACs. For example, Paris was largely a response to the concern in the development aid industry that aid modalities were undermining “ownership” in recipient countries, but this is less of an issue in countries where aid plays a far smaller role in the

economy (Glennie et al, 2012). Is it so important that aid money “use country systems” in (V)LACs, for example, where the distortionary impact of not doing so is marginal, and where an important role for foreign aid is often to challenge the state, including with projects outside of the state’s direct remit.

While recognising some important steps forward taken by signatories of the Paris Agenda, the very different set of questions about aid effectiveness in (V)LACs means that there needs to be a very different discussion from the one commonly associated with Paris.

### 3. Conclusion

“Is it not time for these arcane income thresholds for ‘graduating’ from ‘low-income’ status to be laid to rest?”

*Martin Ravallion, Director of the World Bank’s Development Research Group*

In this paper we have looked briefly at the needs of Middle Income countries, and presented an alternative classification system which, while imperfect and partial, helps to shed some light on the role aid plays and how it could be more effective. It may be that many such classifications are required to assist aid decisions, rather than the simplistic LIC vs MIC dichotomy (and indeed some donors do look at other categories, such as environmental vulnerability).

We have left many questions unanswered and ideas yet to be developed, but are able to share the following summary conclusions:

#### The MICs category is of only marginal usefulness in this debate

The MICs category covers three quarters of the world’s developing countries. In simple mathematical terms, it is questionable how useful it is in influencing aid policy decisions. A range of other categorisations may be needed to help the aid community in its allocation and effectiveness decisions. Assessing countries in terms of their historic levels of aid/GNI may be one such useful tool.

#### Prioritizing scarce resources can be confused with assessing actual need

The “bottom billion” approach to aid allocation, focusing interventions on fragile states and questioning the role of international cooperation in MICs (Collier, 2007), makes sense if funds are strictly limited, although even then there are issues of effectiveness (not only diminishing returns, but also actual harm from aid dependency, see Glennie

2008). But sometimes the need to prioritise is confused with an actual needs analysis i.e. the line between not needing *as much* and not needing *at all*. As well as the debate about how to cut the cake, we need to maintain the debate about the *size* of that cake, and poverty and sustainability needs in MICs need to be recognised. The language of

\$1/day poverty, while useful, may have skewed our understanding of what constitutes need and poverty.

### **Aid as a small proportion of GNI can be an important pro-development intervention**

As countries move up the income scale, foreign public inflows will become less important in terms of their quantity. Other issues become even more important (to provide an “enabling environment” for poverty reduction and sustainable development). Nevertheless, aid can still be effectively invested in countries well up the income scale, depending on their particular circumstances. Most poor have for some decades lived in countries which rely very little on aid. Unless there is a significant difference between aid at, say 0.4% and 0.2% of GNI, there is no logical reason why levels of aid that were useful in the past cannot remain useful today.

Even if it were true that some countries could theoretically now end poverty (using a generous definition) independently, which it is not for most countries, it is likely also to be the case that they could do so faster and more effectively with international support, financial or otherwise. This implies that cutting assistance to MICs is not a consequence of a correct need analysis, but rather based on the willingness or otherwise of wealthier countries to help linked to a) reduced money in their own exchequers and b) economic competition with emerging economies.

“The evaluation [of aid to Colombia] found that in certain fields – such as the environment, institutional strengthening, and productive system support, as well as problems related to the struggle against inequality, internal displacement and human rights violations – the selective use of aid financing, expertise and shared experience was a ‘determining factor in achieving better development results’.”

*Evaluation of the Paris Declaration by Wood et al, 2011*

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### III. Session Report: Global Partnership and its implication on MICs Messages to the Ministerial-level Meeting

Chair: Gerardo Bracho, Senior Policy Advisor, OECD/DAC - Mexico

Rapporteur: Christophe Bonneau, Middle-income countries programme, UNDP Seoul Policy Centre

#### Context:

The first Ministerial-level of the Global Partnership for Effective Development Co-operation, which will take place in April 2014 in Mexico, will give a particular focus on the middle-income country (MIC) category in development co-operation. As part of the Busan Global Partnership Workshop of 18-19 November 2013, a session was dedicated to the MICs, as a contribution to setting the upcoming debate. The session benefited from substantial input from participants, most particularly from Mr. Cao Manh Cuong, Deputy Director General, MPI Vietnam, who made a case-study presentation on the challenge of graduation to middle-income status in Vietnam.

#### Messages:

On the one hand, there was a general consensus that the definition of middle-income country (MIC) based on income per capita is **not satisfactory** for the classification of countries.

- MICs are indeed a highly **heterogeneous** category (size, population, state capacity, development potential, economic and social achievements and performance, resources...).
- Also, the so-called '**graduation**' process from low to middle-income status is profoundly misleading. It implies that moving from low-income to middle-income is an irreversible phenomenon. Also, 'graduating' to middle-income status is sometimes due to factors other than development.

On the other hand, participants recognized:

- The significance of this categorization, being **used** in various ways by a number of bilateral and multilateral donors, as well as by various non-development actors. Any re-categorization should embrace not only the MICs, but also donors, by offering a definition which can be effectively used as a basis for aid allocation, and by low-income countries, by offering a definition which does not simply move away aid from one category to another.
- The existence of **common challenges** in a number of areas (inequality, competitiveness, environment...). Notably, the concept of middle-income trap highlights the problem for countries to move from labor intensive to technology intensive products. Re-categorization should provide a reliable framework to effectively address those challenges.

Participants suggested a number of further studies:

- Analyzing the **reasons** why a certain country moves up from low-income to middle-income status.
- Exploring issues of **aid reduction**, and lessons from countries which managed, or are in the process of, reducing their aid dependency.
- Exploring **key development challenges** of MICs and how some countries overcame, or are overcoming, these obstacles.



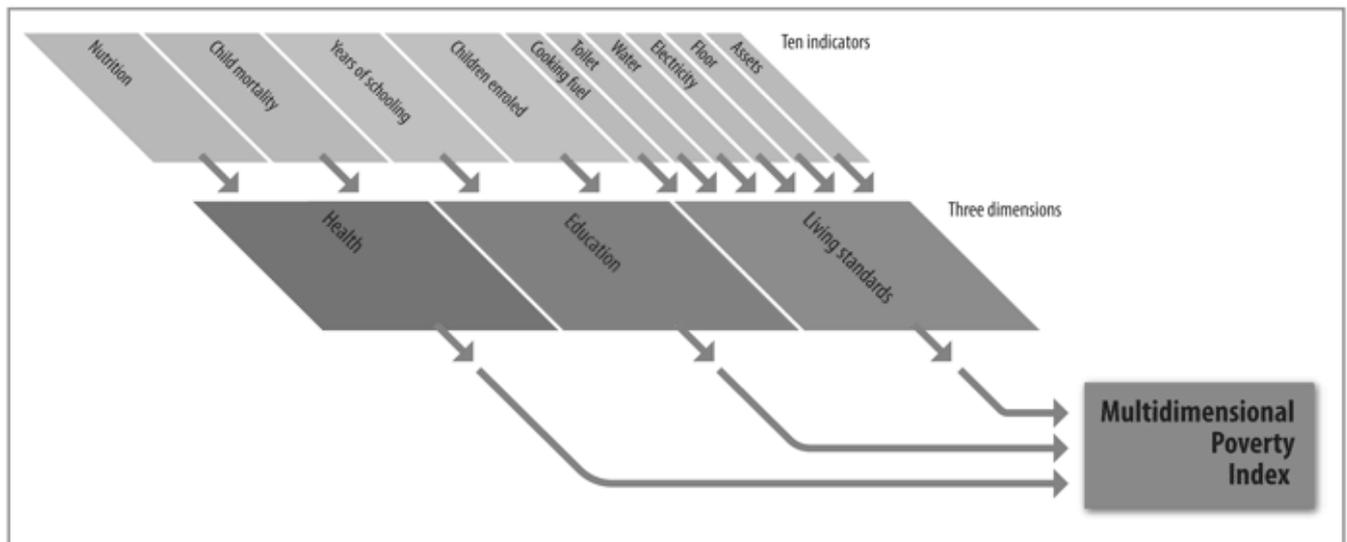
## ANNEX: Multidimensional Poverty Index (MPI)

Source: *Human Development Report 2013*

Like development, poverty is multidimensional — but this is traditionally ignored by headline figures. The Multidimensional Poverty Index (MPI), published for the first time in the 2010 Report, complements money-based measures by considering multiple deprivations and their overlap. The index identifies deprivations across the same three dimensions as the HDI and shows the number of people who are multidimensionally poor (suffering deprivations in 33% of weighted indicators) and the number of deprivations with which poor households typically contend. It can be deconstructed by region, ethnicity and other groupings as well as by dimension, making it an apt tool for policymakers.

### Components of the Multidimensional Poverty Index

MPI—three dimensions and 10 indicators



Note: The size of the boxes reflects the relative weights of the indicators.

Source: Alkire and Santos 2010.

About 1.7 billion people in the 109 countries covered by the MPI—a third of their population — live in multidimensional poverty — that is, with at least 33 percent of the indicators reflecting acute deprivation in health, education and standard of living. This exceeds the estimated 1.3 billion people in those countries who live on \$1.25 a day or less (though it is below the share who live on \$2 or less).

## Methodology

Each person is assigned a deprivation score according to his or her household's deprivations in each of the 10 component indicators. The maximum score is 100%, with each dimension equally weighted; thus the maximum score in each dimension is 33.3%. The education and health dimensions have two indicators each, so each component is worth  $33/2$ , or 16.7%. The standard of living dimension has six indicators, so each component is worth  $33.6/6$ , or 5.6%.

The thresholds are as follows:

- Education: having no household member who has completed five years of schooling and having at least one school-age child (up to grade 8) who is not attending school.
- Health: having at least one household member who is mal-nourished and having had one or more children die.
- Standard of living: not having electricity, not having access to clean drinking water, not having access to adequate sanitation, using "dirty" cooking fuel (dung, wood or charcoal), having a home with a dirt floor, and owning no car, truck or similar motorized vehicle while owning at most one of these assets: bicycle, motorcycle, radio, refrigerator, telephone or television.

To identify the multidimensionally poor, the deprivation scores for each household are summed to obtain the household deprivation,  $c$ . A cut-off of 33.3%, which is the equivalent of one-third of the weighted indicators, is used to distinguish between the poor and nonpoor. If  $c$  is 33.3% or greater, that household (and everyone in it) is multidimensionally poor. Households with a deprivation score greater than or equal to 20% but less than 33.3% are vulnerable to or at risk of becoming multidimensionally poor. Households with a deprivation score of 50% or higher are severely multidimensionally poor.

The MPI value is the mean of deprivation scores  $c$  (above 33.3%) for the population and can be expressed as a product of two measures: the multidimensional headcount ratio and the intensity (or breadth) of poverty.

The headcount ratio,  $H$ , is the proportion of the population who are multidimensionally poor:

$$H = \frac{q}{n}$$

where  $q$  is the number of people who are multidimensionally poor and  $n$  is the total population.

The intensity of poverty,  $A$ , reflects the proportion of the weighted component indicators in which, on average, poor people are deprived. For poor households only ( $c$  greater than or equal to 33.3%), the deprivation scores are summed and divided by the total number of poor persons:

$$A = \frac{\sum_1^q c}{q}$$

where  $c$  is the deprivation score that the poor experience. The deprivation score  $c$  of a poor person can be expressed as the sum of deprivations in each dimension  $j$  ( $j = 1, 2, 3$ ),  $c = c_1 + c_2 + c_3$ . The contribution of dimension  $j$  to multidimensional poverty can be expressed as

$$\text{Contrib}_j = \frac{(\sum_1^q c_j)/n}{\text{MPI}}$$

### Example using hypothetical data

Indicator	Household				Weights
	1	2	3	4	
Household size	4	7	5	4	
<b>Education</b>					
No one has completed five years of schooling	0	1	0	1	$\frac{1}{3} \div 2$ or 16.7%
At least one school-age child not enrolled in school	0	1	0	0	$\frac{1}{3} \div 2$ or 16.7%
<b>Health</b>					
At least one member is malnourished	0	0	1	0	$\frac{1}{3} \div 2$ or 16.7%
One or more children have died	1	1	0	1	$\frac{1}{3} \div 2$ or 16.7%
<b>Living conditions</b>					
No electricity	0	1	1	1	$\frac{1}{3} \div 6$ or 5.6%
No access to clean drinking water	0	0	1	0	$\frac{1}{3} \div 6$ or 5.6%
No access to adequate sanitation	0	1	1	0	$\frac{1}{3} \div 6$ or 5.6%
House has dirt floor	0	0	0	0	$\frac{1}{3} \div 6$ or 5.6%
Household uses "dirty" cooking fuel (dung, firewood or charcoal)	1	1	1	1	$\frac{1}{3} \div 6$ or 5.6%
Household has no car and owns at most one of: bicycle, motorcycle, radio, refrigerator, telephone or television	0	1	0	1	$\frac{1}{3} \div 6$ or 5.6%
<b>Results</b>					
Household deprivation score, $c$ (sum of each deprivation multiplied by its weight)	22.2%	72.2%	38.9%	50.0%	
Is the household poor ( $c > 33.3\%$ )?	No	Yes	Yes	Yes	

Note: 1 indicates deprivation in the indicator; 0 indicates nondeprivation.

Weighted deprivations in household 1:

$$(1 \cdot 16.67) + (1 \cdot 5.56) = 22.2\%.$$

Headcount ratio ( $H$ ) =

$$\left( \frac{7 + 5 + 4}{4 + 7 + 5 + 4} \right) = 0.800$$

(80% of people live in poor households).

Intensity of poverty ( $A$ ) =

$$\frac{(72.2 \cdot 7) + (38.9 \cdot 5) + (50.0 \cdot 4)}{(7 + 5 + 4)} = 56.3\%$$

(the average poor person is deprived in 56.3% of the weighted indicators).

$$MPI = H \cdot A = 0.8 \cdot 0.563 = 0.450.$$

Contribution of deprivation in:

Education:

$$Contrib_1 = \frac{16.67 \cdot 7 \cdot 2 + 16.67 \cdot 4}{4 + 7 + 5 + 4} / 45.0 = 33.3\%$$

Health:

$$Contrib_2 = \frac{16.67 \cdot 7 \cdot 5 + 16.67 \cdot 4}{4 + 7 + 5 + 4} / 45.0 = 29.6\%$$

Living conditions:

$$Contrib_3 = \frac{5.56 \cdot 7 \cdot 4 + 5.56 \cdot 4 \cdot 3}{4 + 7 + 5 + 4} / 45.0 = 37.1\%$$

Calculating the contribution of each dimension to multidimensional poverty provides information that can be useful for revealing a country's configuration of deprivations and can help with policy targeting.

## Notes

1 The inequality aversion parameter affects the degree to which lower achievements are emphasized and

higher achievements are de-emphasized.

2  $A_x$  is estimated from survey data using the survey weights,

$$\hat{A}_x = 1 - \frac{X_1^{w_1} \dots X_n^{w_n}}{\sum_1^n w_i X_i}, \text{ where } \sum_1^n w_i = 1.$$

However, for simplicity and without loss of generality, equation 1 is referred to as the Atkinson measure.





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**CHALLENGES OF THE  
MIDDLE-INCOME COUNTRIES  
SEOUL DEBATES 2013**



*Empowered lives.  
Resilient nations.*



Korea Institute for International  
Economic Policy