# Industrial policies to escape from the middle income trap: cases of Uruguay and Malaysia.

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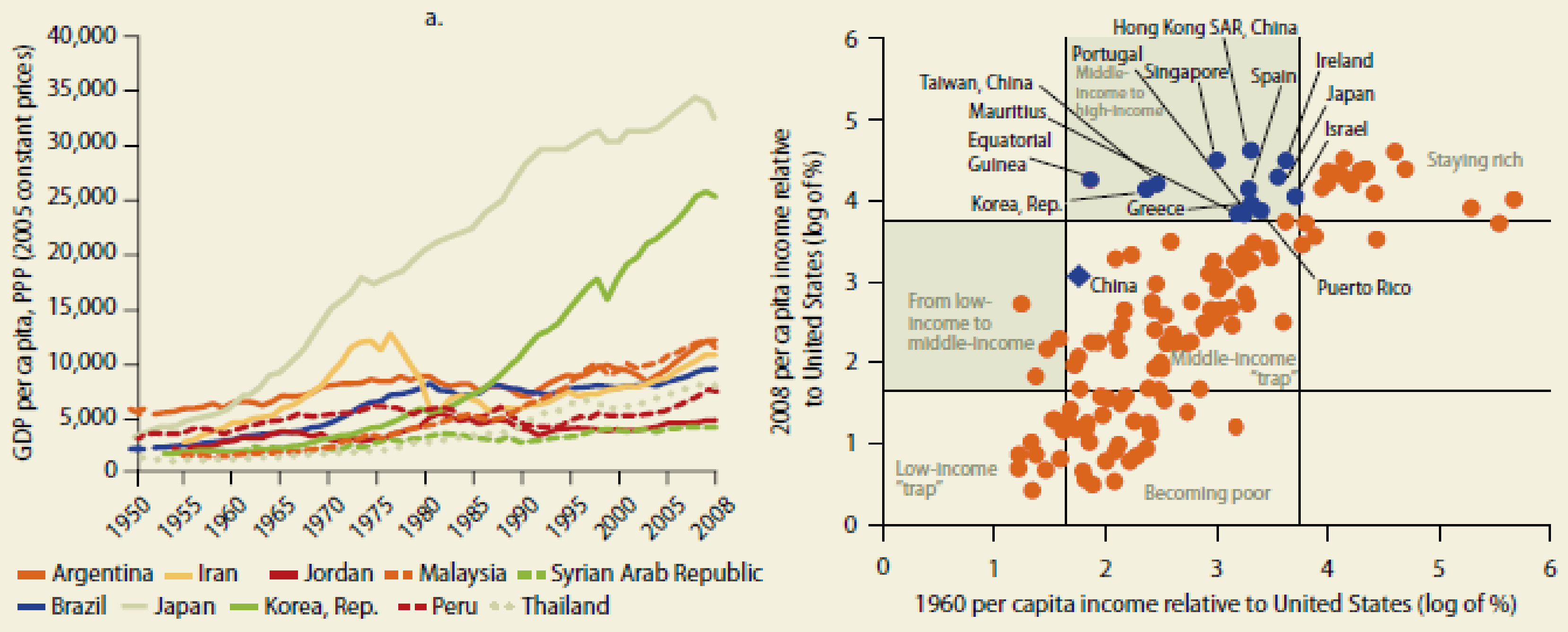
***Of 101 middle-income economies in 1960, only 13 became high income by 2008. Other countries, thus, were caught in what was coined as the "middle income trap".***

***World Bank (2012)***

**Figure BO.1.1** **Few economies escape the middle-income trap**

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## FACTS ABOUT THE MIDDLE INCOME TRAP

*Productivity growth slowdown (Eichengreen et al, 2011).*

*Domestic industries start relying less on investment and more on innovation*

*Saturation of the factors and advantages that generate high income growth during the initial phase of rapid development*

*Inability to effectively compete with both low-wage and high-income competitors due to the lack of innovative capabilities*

*Marginal productivity of capital declines, and rising wages reduce the international competitiveness of labor-intensive industries.*

*No clear threshold number of years in economic literature for a country to be in the middle-income trap*

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## FOCUS OF THE STUDY

- *Malaysia - the only upper middle-income country among Asian countries in the middle-income trap.*
- *It became a lower middle-income country in 1969, turned an upper middle-income country in 1996 and still remains in this status.*

- *Uruguay - in 2013 along with other four countries - Chile, Latvia, Lithuania and Russian Federation - changed its status from the upper-middle income to the high-income class*
- *It turned a lower middle-income country in 1882 and became an upper-middle income country only in 1994. Thus, Uruguay had retained the status of upper-income country for 18 years before graduating in 2012.*

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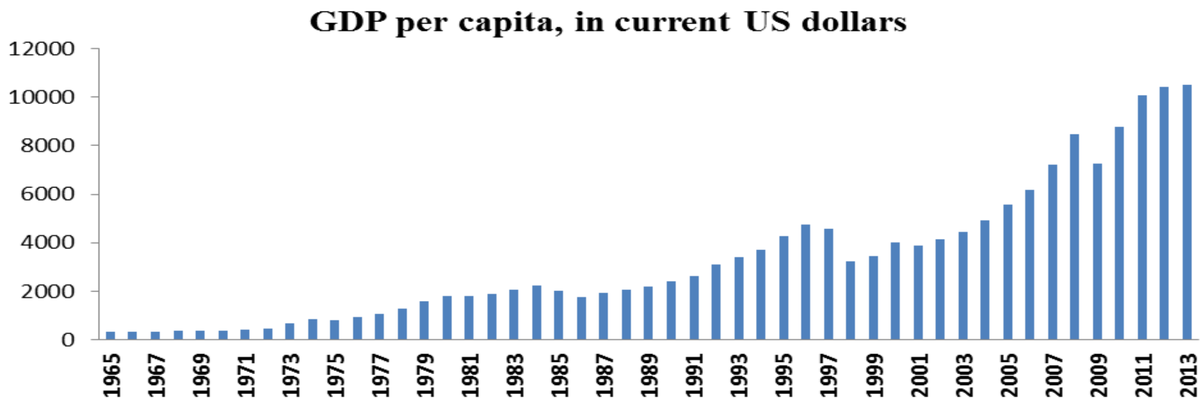
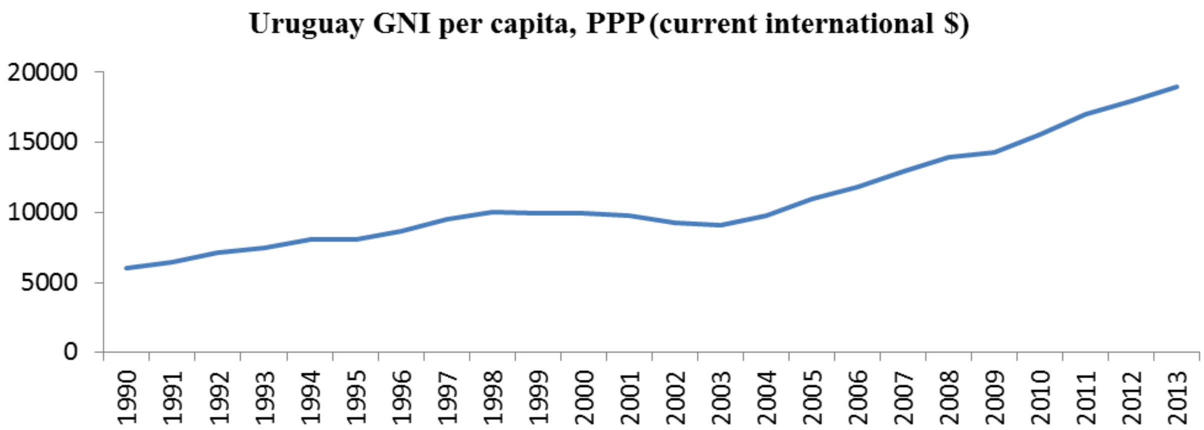
# MALAYSIA VS URUGUAY

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## WHAT POLICIES SHOULD BE ADOPTED TO AVOID FALLING INTO THE MIDDLE-INCOME TRAP?

- *Move into production of technologically sophisticated goods.*
- *Direct policy efforts to upgrade the education system and develop institutes necessary to cultivate the ability of countries to move from imitating and importing foreign technologies to innovating technologies of their own.*
- *High-quality institutions: reputable bureaucracy, good legal system, contract enforcement and property rights, small scale of government involvement in the economy.*

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## IN 1988 KOREA BECAME AN UPPER MIDDLE-INCOME COUNTRY, 8 YEARS AHEAD OF MALAYSIA, AND IN 1995 IT BECAME A HIGH-INCOME COUNTRY.

- *South Korea exported more new sophisticated products than Malaysia in 5-year periods spanning from 1965 to 2005 (36 in comparison to 13).*

| | Sophisticated products | | Near sophisticated products | | Unsophisticated products | |
|---|---|---|---|---|---|---|
| | Korea | Malaysia | Korea | Malaysia | Korea | Malaysia |
| 1965-1970 | 1 | 1 | 5 | 6 | 11 | 9 |
| 1970-1975 | 9 | 3 | 13 | 6 | 24 | 15 |
| 1975-1980 | 6 | 2 | 18 | 4 | 19 | 7 |
| 1980-1985 | 5 | 2 | 6 | 7 | 12 | 18 |
| 1985-1990 | 4 | 2 | 7 | 15 | 23 | 34 |
| 1990-1995 | 3 | - | 18 | 5 | 21 | 18 |
| 1995-2000 | 2 | - | 10 | 4 | 25 | 15 |
| 2000-2005 | 6 | 3 | 10 | 6 | 11 | 13 |

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# WHY DID MALAYSIA FAIL?

1) ***Flaws in the industrial policy.*** *Although, the industrial policies of Malaysia had some substantial achievements (manufacturing rose from 13,4% to 30,5% as a share of GDP), they contained inefficiencies in the implementation.*
2) ***Fallacies in the New Economic Policy (1971).*** *While it was aimed at eradicating poverty and disseminating equality, it put too much emphasis on wealth redistribution restricting the economic growth.*
3) ***Episodes of recession in the world economy.*** *The effects of these events were worsened by economic inefficiencies due to the reasons described above.*

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# FLAWS IN THE INDUSTRIAL POLICY

***Import-substituting industrialisation (Jomo, 2002):***

- *the goods were produced predominately for the domestic market*
- *high protective barriers: the subsidy equivalent of protection for 1969 was just fewer than 4 per cent of GDP, or about 14% of total government operating expenditure (Edwards (1975:1998))*
- *limited employment-generating capacity owing to the utilisation of typically capital-intensive foreign technology*
- *weak linkages of these industries with the rest of the national economy due to little sophistication of their products*
- *small domestic market.*

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## FLAWS IN THE INDUSTRIAL POLICY

***Export-oriented industrialisation***

- *industries more sensitive to changes in wage costs => the government tries to ensure that the investment climate remains attractive for investment*
- *dominance of unsophisticated production: electrical components assembly (50%) and textile manufacturing (12%) => weaknesses in the integration of the industrial sector products with products from other sectors of the economy.*
- *total trade exceeded 50% of GDP in 1980 (Bowie, 1988) => following the worldwide recession in 1980 the country's terms of trade declined by 15%. Growth slowdown episode lasted from 1980 to 1985 (Aiyar et al, 2013).*

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## FLAWS IN THE INDUSTRIAL POLICY: WAGE RATES

| Economy | Growth rate of real manufacturing in the 1970s (%) | Average monthly salaries of industrial workers, 1978 (US$) |
|---|---|---|
| S. Korea | 9,0 | 316 |
| Taiwan | 7,2 | 165 |
| Hong Kong | 2,4 | 254 |
| Singapore | 6,5 | 198 |
| Malaysia | 1,4 | 150 |

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## FLAWS IN THE INDUSTRIAL POLICY

***Heavy industrialisation***

- *brought some important results: in the period from 1985 to 1990 Malaysia produced more new sophisticated products than before and even after.*
- *retained some weaknesses of previous policies: small employment-generating capacity, government protection, weak linkages with the rest of the economy*
- *dependence on external borrowing*

*=> rapid increase in the net public foreign borrowing from 10 per cent in 1980 to more than 38 per cent in 1986 (Ministry of Finance, Economic Report (1981)).*

*=> real effective exchange rate appreciation through the first half of the 1980s*

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## FALLACIES IN THE NEW ECONOMIC POLICY

*The NEP is often accused of placing the wealth redistribution ahead of the wealth creation. Woo (2009) points out to the following fallacies:*

- ***Institutionalisation of discrimination** through denying top leadership positions to Chinese and Indians => employing less than 60 percent of the national talent pool (Woo, 2009).*
- ***Ethnic quotas on ownership structure***

*=> discouraged successful Chinese Malaysian firms from tapping local stock market to fund expansion*

*=> drove Chinese Malaysian firms to move headquarters abroad*

- ***Ethnic quotas on bank loans, business licenses, government contracts, and employment** => corruption, perpetual infant industry phenomenon, "money politics", and increasingly frequent outrageous rulings by the Malaysian courts.*

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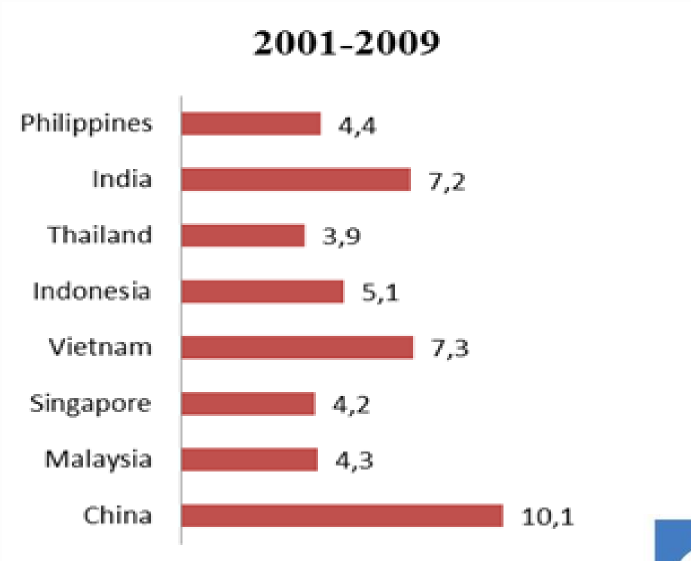
## FALLACIES IN THE NEW ECONOMIC POLICY

- *Much of substantial investments into education was spent on tertiary education, especially abroad, with little emphasis on skill development at intermediate levels, innovation and adaptation.*
- *The literacy rate in Malaysia had been significantly lower in Malaysia than in successful East Asian countries.*

| Economy | 1980 | 1990 | 2000 |
|---|---|---|---|
| S. Korea | 96 | 98 | 99 |
| Thailand | 93 | 95 | 97 |
| Hong Kong | 90 | 96 | 97 |
| Singapore | 84 | 94 | 96 |
| Malaysia | 60 | 87 | 91 |

**INFLUENCE OF EPISODES OF RECESSION IN THE WORLD ECONOMY**

- *1985 => contraction in GDP at 1,1% (was the worst performance ever recorded).*
- *The Asian financial crisis of 1997 => in 1998 the economy suffered a severe contraction due to the significant decline in aggregate demand.*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## REASONS FOR POOR GROWTH IN RECENT YEARS

- ***Slow labour productivity growth*** *(New Economic Model for Malaysia, 2010). The report by the National Economic Advisory Council provides two reasons for slow labour productivity growth in Malaysia: insufficient private investment and low human capital development.*
- *Private investment grew at just 2% per year in 2006-2010 rather than the 10% projected in the Ninth Malaysia Plan. The reasons for such sluggish growth were acknowledged to be the* ***high costs of doing business in Malaysia, lengthy bureaucratic procedures, investors' concern about the availability of skilled professionals and inadequate opportunities for investment*** *(Economic Transformation Programme, 2010).*
- ***Low human capital development*** *is due to the labour market in Malaysia being characterised by its reliance on a low-cost, low-skilled workforce*

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**SUM UP (MALAYSIA)**

- *Industrialisation process accompanied by* ***ineffective government policies****. In particular, the government failed to create competitive manufacturing sector with strong linkages with the rest of the economy.*
- *Pursuing* ***wealth redistribution*** *policies instead of focusing solely on wealth creation. This situation was made worse by the failure of the government to develop human capital in line with their industrial aspirations.*
- *Resulting in* ***low labour productivity****, the above reasons led to the inability of Malaysia to resist to economic doldrums and thus led to the country being stuck in the middle-income trap".*

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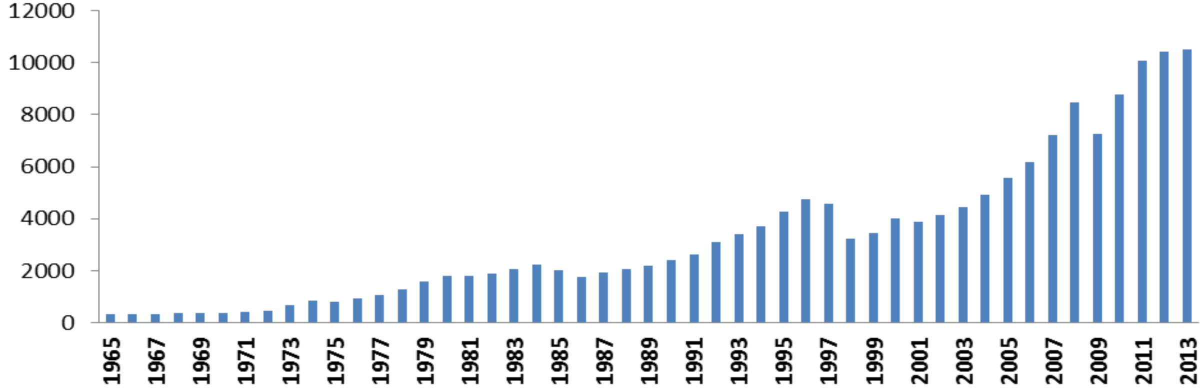
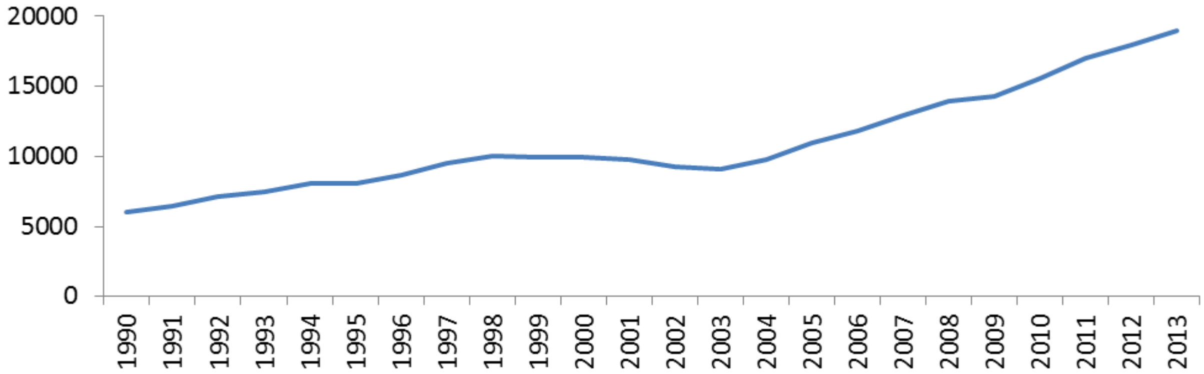
# MALAYSIA VS URUGUAY

GDP per capita, in current US dollars




Uruguay GNI per capita, PPP (current international $)

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## WHY DID URUGUAY SUCCEED?

*Key factors: **democratic and inclusive institutions**.*

- *The new strategy of industrial reforms has achieved success in attracting investments, increasing exports and creating technological clusters mainly due to political and macroeconomic stability that was maintained by the institutions.*
- *Moreover, the critical factor that underpinned the industrial strategy was the high level of coordination and collaboration with the private sector that was provided by the inclusive nature of institutions.*

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## URUGUAY: STRONG AND INCLUSIVE ECONOMIC GROWTH IN THE RECENT 25 YEARS

*Reasons:* ***important institutional reforms, friendly business environment and stable macroeconomic environment***

- *social policies encouraging progressivity and coverage for all groups of society.*
- *exports promotion, innovation policy and foreign direct investment attraction and inclusive social policies. Liberalization of foreign trade along with the integration into the Southern Cone Common Market (Mercosur) in the 1990s*
- *a level of political stability and continuity outstanding in the regional context*
- *establishing a supportive environment for the innovation cluster and introducing the Directives for Industrial Development. Microeconomic incentives focused at resolving the market and public failures*

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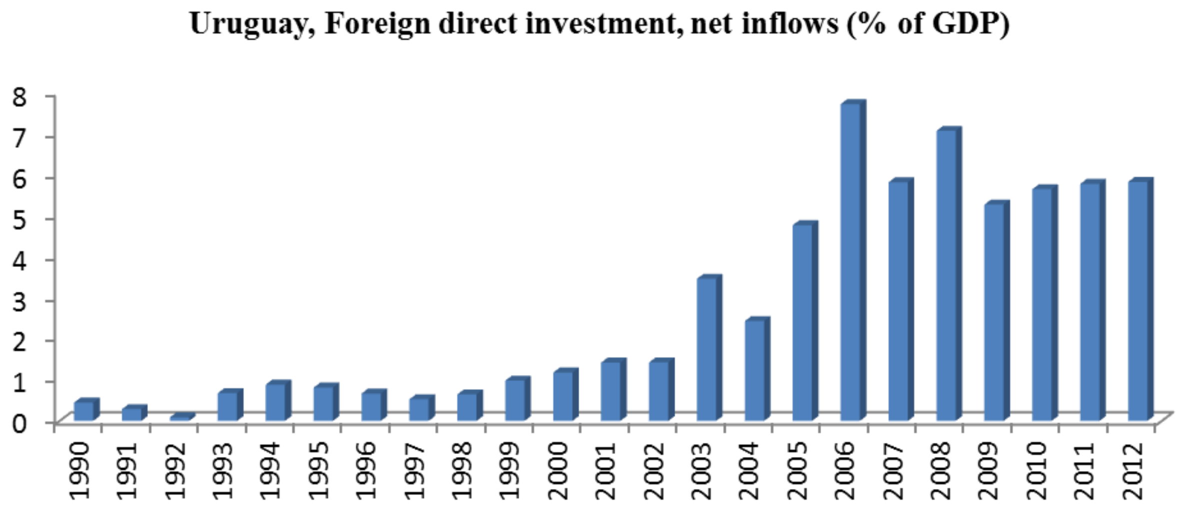
# FDI IN URUGUAY

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## NEW APPROACH TO INDUSTRIALISATION

- *Complex strategy with a new set of industrial policies aimed at fostering innovation and establishing technology clusters*
- *New central institutions – the Department of Support to the Private sector and the National Agency for Research and Innovation.*
- *Development of industrial and innovation programs in coordination with the private sector through the coordination councils.*
- *Establishment of research networks that would behoove and support the creation of the technological clusters.*

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## ROLE OF THE STATE

*In Uruguay the state acquired a **leading role** in the economy and took the responsibility for the provision of all kinds of public services.*

- *The Vázquez administration's economic team increased public expenditures, especially in education, health and the support of the poorest groups.*
- *Social policies in Uruguay have achieved a reduction in inequality and poverty with social spending being equivalent to 21.1% of GDP in 2009*
- *State intervention in the economy focused at solving real marker failures in collaboration with the private sector*

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## MALAYSIA VS URUGUAY

*Why Malaysia failed at graduating into the high-income status?*

- *Three reasons contributed: ineffective government policies in carrying industrialisation, imposition of limits on economic growth by the New Economic Policy and inability of the Malaysian economy to escape from harmful effects of economic recessions.*

*Why Uruguay succeeded?*

- *Three major factors: the quality of democratic and inclusive institutions, exports promotion, innovation policy and foreign direct investment attraction and inclusive social policies.*

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# CONCLUSION

***The critical component necessary to escape from the middle-income trap is effective institutions.***

- *In particular this means the need for effective and small government. Malaysia failed in this area because it was too actively involved in the industrialisation process picking winners and caring too much about interracial wealth distribution. In contrast, Uruguay developed democratic institutions that were focused on providing sufficient conditions for private sector to thrive.*
- *The government in Malaysia was not totally ineffective. However, as the economy matured, the government failed to limit its role and allow for pure competition. When in the beginning of the1990s Malaysia made steps in the direction of limiting the public sector and shifting economic powers to the private sector, it achieved on of the highest growth rates in Asia.*

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## RECOMMENDATIONS

1) *it is essential to develop industry sector based on the* ***production of highly sophisticated products****. This is because production of sophisticated goods creates better linkages with other sectors in the economy.*
2) *it is essential to* ***develop human resources*** *as the process of industrialisation proceeds. This will increase the labour productivity and, thus, help to achieve the first objective.*
3) *once the industrial sector matures, it is important for the* ***private sector to expand*** *into the areas previously occupied by the public sector. At the end of the day the business of the government is not to do business, it is to govern!*

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# Thank you!