Simeon Djankov: Avoiding the Middle-Income Trap

Published in Russian at http://www.forbes.ru/mneniya-column/konkurentsiya/250548-kak-ne-popast-v-lovushku-srednego-dokhoda

At the Gaidar Forum three weeks ago, Prime Minister Medvedev focused on the challenges for Russian economic growth. The main challenge, he argued, comes from the middle-income trap that many economies fall into once they reach a certain income level. The Prime Minister cited research by Professor Barry Eichengreen, from the University of California at Berkeley, who finds that once countries reach $15,000 income per capita, their economic growth slows on average from 6% to about 2% a year. This pattern of slowed growth holds over a very long period – from 1956 to 2010.

This is a worrying finding, since Russia will reach this income level in 2014, according to figures by the International Monetary Fund. Does this mean that as wages and general incomes have risen, and Russia's cost competitiveness has deteriorated, what follows is a period of stagnation? In addition to Eichengreen's analysis, there are at least three reasons to think so.

First, Russia's economy is significantly dependent on the energy sector, and oil and gas in particular. However, recent technological developments in the exploration of shale gas make the future income stream from energy revenues less certain. This is exacerbated by a drive towards energy efficiency in much of Europe, and a goal of having 16% of energy consumption in the European Union come from renewables by the year 2020.

Second, unfavorable demographic trends suggest that between 2010 and 2030 Russia's working-age population will shrink by about 15%. This means more retired people per worker, and hence an increase in pension spending that could reduce the opportunities for public investment. It also means that the cost of labor will be increasing, and with it the burden on Russia's export competitiveness.

Third, there is an overall disillusionment with middle-income countries (or emerging markets, as they are also called), and foreign investment has markedly slowed down. In stock exchanges, emerging markets indices, and in particular the BRICs, have underperformed. In 2013, for example, net returns in emerging markets were -3%, in the BRICs -4%, while in the United States there were 33% and in Europe over 20%. And it is not just last year. If we compare net returns in a three-years or a five-years period, emerging markets still trail the United States, and do about the same as OECD countries. Several of the large middle-income countries also display macroeconomic instability that worries investors. This is why the currencies of Argentina, India, Indonesia and Turkey have tumbled since the beginning of the year. And even though Russia's monetary and fiscal policies are strong, the malaise elsewhere is contagious.

All this said, there are ways for Russia to avoid the middle-income trap. Professor Eichengreen's research suggests two. First, by investment in secondary and tertiary education. And second, by increasing the share of research and development (R&D) in export growth. Countries that have used this strategy have managed to escape the trap: recent examples include Korea and Chile.

The Russian government is already investing more in tertiary education. I have witnessed, for example, how the Top-500 initiative – an initiative of the government to support a dozen universities through grants with the goal of entering the list of top-500 global universities – is starting to bear fruit. In focusing the effort of universities on international competition, the government will likely achieve an increased standard for teaching university students and for research activities. This, in turn, will help attract better students, who may otherwise seek education abroad.

Increasing R&D-driven exports is a more difficult task, as it involves linking the traditionally-strong applied research work in Russia with production. They are several sectors where Russia has great tradition: software, aerospace, nuclear, chemicals. Expanding exports from these sectors may be the best starting point.

A third way for Russia to avoid the middle-income trap is to rapidly improve the business environment. What professor Eichengreen omits to say, is that Korea– his example of a country overcoming the trap – did so by expanding the opportunities for doing business beyond just large enterprises. In particular, Korea ranks 7th in the world on the Ease of Doing Business indicators by the World Bank. This means the environment for small and medium companies to operate is attractive. Russia has taken a great stride in improving its business regulations. In the latest Doing Business rankings it shot up by twenty places, and now is ahead of all other BRICs. It also improved by three positions in the 2013 Economic Freedom of the World ranking. This can be called success, if it can be sustained for several years. Once the ease of doing business in Russia is comparable to that in, for example, Central Europe, investors will take note.

Can Russia avoid the middle-income trap? Of course, it can. It would take a concerted effort to do so, but the ingredients are clear.