The Growth Elixir: Escaping the Middle-Income Trap in Emerging Markets

INSTITUTE FOR EMERGING MARKET STUDIES (IEMS)
MOSCOW SCHOOL OF MANAGEMENT SKOLKOVO

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Author:
Dr. Christopher Hartwell, Senior Research Fellow

Editor-in-Chief:
Seung Ho "Sam" Park, Executive Director

Contents

Executive Summary

Global growth by any metric has been the rule, not the exception

There are few places in the world where quality of life was not better in 2010 than in 1960, although certain regions have shown incredible success and others have stagnated. Growth paths have not been self-sustaining in many countries, with plateau effects after attaining certain thresholds of per capita income. This phenomenon has been observed in nearly every region of the world and at every income level.

Researchers from the World Bank have dubbed this problem of fading growth for middle income countries exclusively "the middle-income trap," to distinguish it from the "poverty trap" that afflicts poorer countries. With the bulk of emerging markets now approaching middle-income status, and given the reality of slower growth for many countries (and the policy recommendations that currently exist for overcoming this problem), are there lessons to be learned from some of the highest-flying performers of the past three decades?

The key finding of the analysis of emerging market performance over the past 30 years is that the fundamentals still matter. Simply put, macroeconomic stability is necessary at all levels of development, and governments are advised to keep their eyes on maintaining macroeconomic stability (especially in regards to inflation) at all times. Even growth that has been achieved can be wiped out by just one experience of high levels of inflation, and thus, in order to avoid the middle-income trap, macroeconomic stability (including fiscal prudence) must be adhered to. This includes avoiding inflationary temptations (unlike Argentina, Turkey, and other countries that have fallen into the trap), while keeping the overall size of government low (as in Poland and Estonia).

Similarly, we find that institutions are necessary, both political AND economic. In the first instance, the growth of government is generally a sign that a growth slowdown is imminent, often leading to crowding out of private investment and a diminution of the same entrepreneurial spirit that sparked growth in the first place. India is a prime example of this lesson.

Beyond merely the size of government are the institutions that make up the government. In many of the emerging markets we examine, political instability has served as a continuous drag on growth, as in Argentina and sub-Saharan Africa. Thus, as part of a pro-growth package of reforms, countries should strive to construct or solidify political environments that are routine, predictable, and constrained by checks and balances. Policymakers, if they truly wish to help their countries to grow, should be prepared to pursue prudent policies but also to step aside if the polity demands it.

Similarly, policies that encourage the growth of market-oriented economic institutions should be pursued. This list includes property rights, judicial independence, and labor market flexibility, as well as business environment reforms that can help these institutions to emerge and thrive. Many of these crucial "good" economic institutions are still lacking, with property rights being the most important. Other countries have also focused on "bad" institutions that do not contribute to growth, such as tax administration, at the exclusion of other expenditures that could have aided growth.

We believe that if a country's government focuses on these simple prescriptions, the middle-income trap will one day be irrelevant to the study of economic growth.

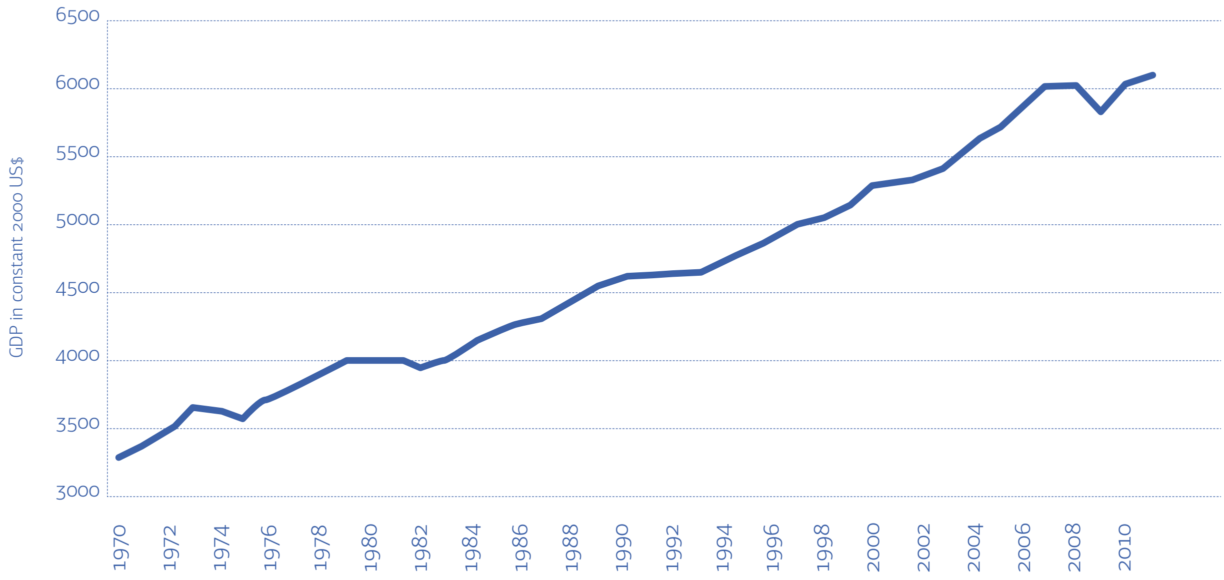
I. Introduction

The fact that poverty, in all its similarity, persists in some regions of the world is a paradox given the experience of the world over the past 40 years. Over this timespan, global growth by any metric has been the rule, not the exception, with currency and debt crises only briefly interrupting an upward trajectory (Figure 1). There are few places in the world where quality of life was not better in 2010 than in 1960 even if, as Figure 2 shows, the growth has not been evenly distributed, with certain regions showing incredible success and others stagnating.

The key to this paradox may be that the global growth shown in Figure 1 masks the fact that growth paths have not been self-sustaining in many countries, with plateau effects after attaining certain thresholds of per capita income. This phenomenon has been observed in nearly every region of the world and at every income level (see Figures 3 and 4), with even countries that had reached a standard of living above subsistence finding difficulties in raising it further. Indeed, this "start-stop" growth has been the real story in economic development over the past two decades; researchers from the World Bank have dubbed this problem of fading growth for middle-income countries exclusively "the middle- income trap," to distinguish it from "the poverty trap" that afflicts poorer countries.[1]

The middle-income trap (hereafter MIT) has been defined as the slowdown in growth once countries reach middle-income levels. In the words of the World Bank, "after exceeding the poverty trap of US$1,000 GDP per capita, many emerging market countries head rapidly to the 'take-off stage' of US$3,000 per capita GDP [b]ut as they near this figure... they experience long-term economic stagnation, divisions between rich and poor become serious, corruption is rampant, and they fall into the 'trap.'"[2] This convention has been picked up by others to utilize the boundaries of the trap: As long as a country stays in the middle-income category, all the way from a GNI of $1,006 to $12,275, it is presumed to have reached middle-

Figure 1. World GDP in constant 2000 US$, 1970-2011



Source: World Bank World Development Indicators

1 Gill, I., & Kharas, H. (2007). An East Asian Renaissance. World Bank Report.

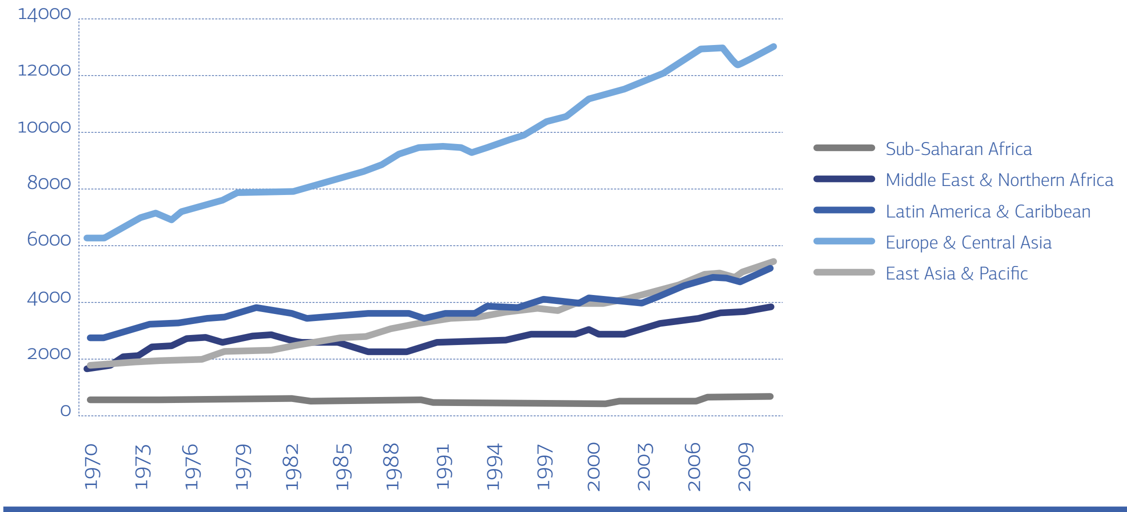
2 Ibid.

income, and it is only when a country exceeds this threshold and becomes "high-income" that it is considered to have "escaped" the middle-income trap.[3]

The MIT literature has made heavy reference to Latin America's experience in the 1980s as the bulk of empirical observations, but other recent work by researchers such as Barry Eichengreen from the University of California-Berkeley has focused on the specific problem of growth slowdowns from (formerly) high-performing countries such as China.[4] Indeed, the MIT is perhaps more interesting because so few countries have escaped it: Of "101 middle-income economies in 1960, only 13 became high-income by 2008—Equatorial Guinea, Greece, Hong Kong SAR (China), Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, the Republic of Korea, Singapore, Spain, and Taiwan."[5] The vast experience outside of this select group was of stagnation, with Latin America, for instance, seeing "income per capita relative to the United States [falling] almost continuously from 1960 to 2005, especially after the debt crises of the early 1980s."[6] According to economists Indermitt Gill and Homi Kharas (who coined the phrase "middle-income trap"), the only "part of the world that has most notably defied this tendency is East Asia."[7]

The policy prescriptions offered in support of breaking out of the "trap" have also varied according to the region and/or the institution doing the examination, although much research has tended towards recommending "strategic, proactive and coherent government policies for the advancement of social and firm-level

Figure 2. World GDP by Region, constant 2000 US$, 1970-2011



Source: World Bank World Development Indicators

3 Of course, these cutoffs are not static, as the frontier is always moving forward and prices are changing. These definitions are based on 2008 development levels, which will naturally become less relevant in the future.

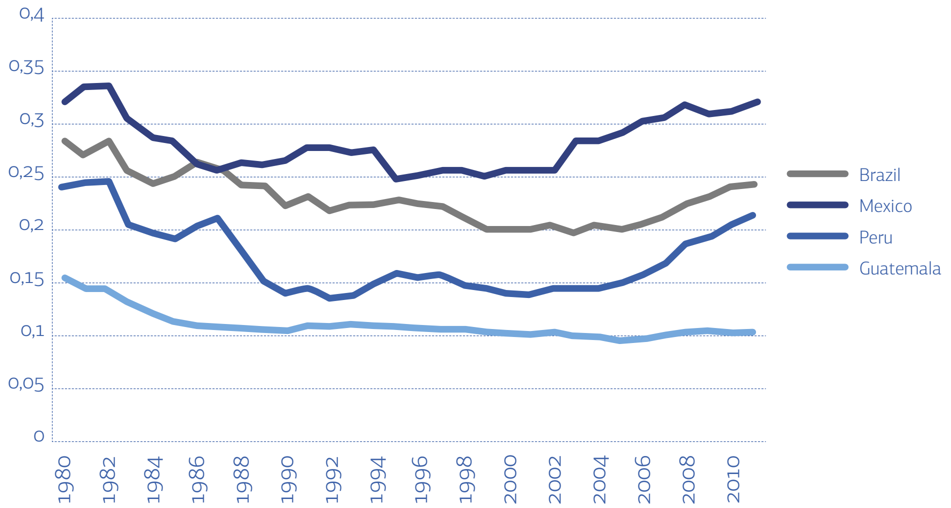
4 See B. Eichengreen, D. Park, & K. Shin (2011). When Fast Growing Economies Slow Down: International Evidence and Implications for China. National Bureau of Economic Research. Retrieved from: http://www.nber.org/papers/w16919.

5 World Bank, (2012). China 2030: Building a Modern, Harmonious, and Creative High-Income Society. Washington, DC: World Bank Press.

6 Agénor,P., Canuto, O., and Jelenic, M. (2012). Avoiding Middle-Income Growth Traps. Economic Premise, No. 98. Retrieved November 27, 2012, from: http://siteresources.worldbank.org/EXTPREMNET/Resources/EP98.pdf?goback=.gde_1292267_member_188665291.

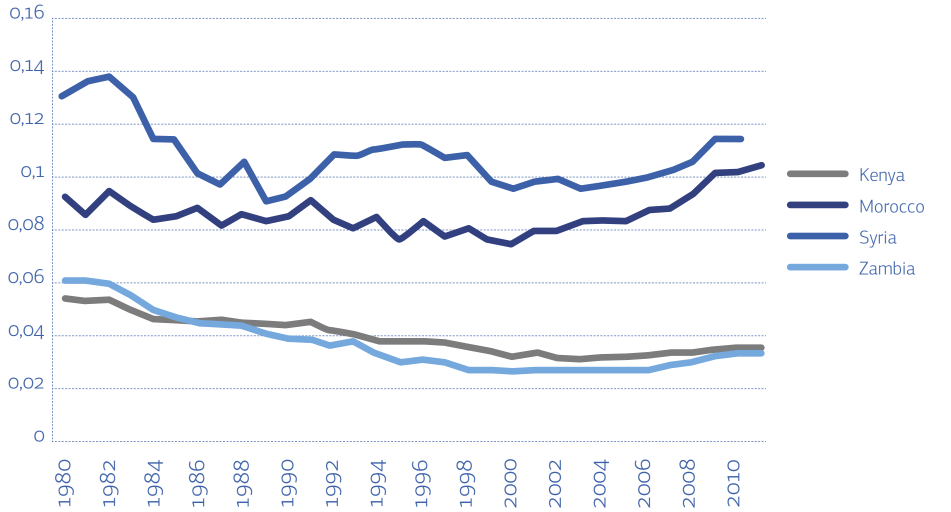
7 Gil, I., & Kharas, H. (2007). An East Asian Renaissance. World Bank Report, p. 53. Retrieved November 26, 2012, from: http://siteresources.worldbank.org/INTEASTASIAPACIFIC/Resources/226262-1158536715202/EA_Renaissance_full.pdf.

Figure 3. GDP Per Capita (PPP) Relative to the US, Middle-Income Latin American Countries



Source: World Bank World Development Indicators

Figure 4. GDP Per Capita (PPP) Relative to the US, Middle- and Low-Income African Countries



Source: World Bank World Development Indicators capabilities."[8] This has been echoed by research from the World Bank that attempts to identify a framework that can "guide policy makers on how to identify new industries consistent with a country's latent comparative advantage"; this research also notes that "government should play an active role in facilitating industrial upgrading and infrastructure improvements."[9]

There are few places in the world where quality of life was not better in 2010 than in 1960

However, it appears that many of the cases cited as being those of the middle-income trap do not have novel issues that are slowing their growth. A careful reading of emerging markets undergoing a growth slowdown finds that their deviations can be explained mainly by two major factors:

1. Policy failings, including basic macroeconomic stabilization and protectionism, which are already known as detrimental to growth.

2. Deeper structural flaws, and in particular the role of essential economic institutions, which are exposed as minimal growth levels (driven by capital accumulation) are achieved.

With the bulk of emerging markets now approaching middle-income status, and given the reality of slower growth for many countries (and the policy recommendations that currently exist for overcoming this problem), are there lessons to be learned from some of the highest-flying performers of the past three decades? Are there similar critical barriers to growth in the laggard economies that need to be removed in order to attain high growth rates? This paper will go beyond the current exploration of the MIT and focus on the possibly mundane realities of the trap that have been somewhat neglected: the role of policies and institutions. Examining these two dimensions in the context of all emerging markets, we will distill recommendations for policymakers to avoid the middle-income trap.

8 E. Paus (2012). Confronting the Middle Income Trap: Insights from Small Latecomers. Studies in Comparative International Development, Vol. 47, No. 2, 115–138.

9 J. Lin (2012). New Structural Economics : A Framework for Rethinking Development. Washington DC: World Bank. Retrieved from: http://siteresources.worldbank.org/DEC/Resources/84797-1104785060319/598886-1104951889260/NSE-Book.pdf

II. What is Wrong with the Middle-Income Trap: Policy Failings are Not New

There still remain many issues with the way the MIT is currently framed that make this concept somewhat useless for policymakers

The recent focus on the middle income trap and the corresponding empirical research isolating its boundaries has highlighted an important phenomenon in the growth of nations. However, there still remain many issues with the way the MIT is currently framed that make this concept somewhat useless for policymakers. The main issues include:

- *Lack of originality (I).* The MIT is not exactly a new concept in economics and appears to be a remix of the idea of diminishing marginal returns.
- *Timing is everything.* How and when a country becomes stuck in the middle income trap appears to depend entirely upon the eye of the beholder.
- *Lack of originality (II).* Not only is the concept behind the trap not necessarily novel, but the cases often used to prove the trap are in and of themselves not unique. In particular, the countries often cited as being caught in the inexplicable trap face the very same policy and institutional problems that would predictably lead to their plight.
- *Little sense of why a country is in the trap.* Most important for policymakers is this point: If the middle income trap exists, what can be done differently to escape it?

The Trap: Old Wine in a New Bottle

The first, and possibly most damning criticism that can come from an economist, is that the middle income trap (at least as encapsulated in the current literature) is perhaps not really a new phenomenon. Growth slowdowns are part and parcel of economic growth theory (indeed, diminishing marginal returns is the fact underpinning all of economics), as standard growth models predict convergence or a more rapid rate of growth from lower income levels to higher incomes that tapers off as countries become more prosperous.

The reason behind this slowdown can also be traced back to diminishing marginal returns, as accumulation of capital to labor (simply put, providing more equipment for workers) can only take a country so far. During the period of increasing accumulation, economic gains can be brilliant, but they rarely last in the long run: Eventually there are not enough workers to run all the machines. This point, made in the context of the Soviet Union by Paul Krugman and in East Asia by Alwyn Young,[10] is that "the rise in participation rates, investment to GDP ratios, and educational standards and the intersectoral transfer of labor from agriculture to other sectors (e.g., manufacturing) with higher value added per worker" can get a country to a certain level, but then it takes technological change to push the frontier even further.

To be fair, this point has been anticipated by some examining the MIT: The World Bank echoed the research of Barry Eichengreen and his team[11] in noting that the evidence of the middle-income trap is based on "productivity growth slowdowns." Thus, "85 percent of the slowdown in the rate of output growth can be explained by a slowdown in the rate of total factor productivity growth" rather than by "decreasing marginal returns to investment in physical capital, as a simple neoclassical growth model would suggest."[12] Earlier attempts to quantify growth

10 Young, A. (1995). The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience. Quarterly Journal of Economics, 110: 641-80.

11 Eichengreen, B., Park, D., & Shin, K. (2011). When Fast Growing Economies Slow Down: International Evidence and Implications for China.

12 Agénor,P., Canuto, O., & Jelenic, M. (2012). Avoiding Middle-Income Growth Traps. Economic Premise, No. 98. Retrieved November 27, 2012, from: http://siteresources.worldbank.org/EXTPREMNET/Resources/EP98.pdf?goback=.gde_1292267_member_188665291.

slowdowns from the Inter-American Development Bank (IADB) also trace the per capita income gap of Latin America on average to one in Total Factor Productivity (TFP) growth, while differences in factor accumulation are shown to be less important.[13] This finding was seconded by researchers in Latin America, who show that productivity trends in the region followed a secular decline during the second half of the 20th century, reaching an all-time low with the debt crisis in the 1980s.[14] During the years following this episode, productivity growth either collapsed or even turned negative. In contrast, factor accumulation provided a relatively stable contribution to growth, both during expansion and recession years. Indeed, Eichengreen's team found that the residual of total factor productivity falls from unusually high levels of 3 percent plus in periods of high growth to virtually zero in slowdowns, with much lower declines corresponding to capital and labor accumulation.

Economic research has concluded that macroeconomic stability is a necessary (but not sufficient) condition for sustained economic growth and development

However, seeing this view of development as different from "decreasing marginal returns to investment in physical capital" is close to somewhat arbitrarily drawing hard-and-fast boundaries that cannot apply in the real world. While accumulation of technology is necessary, especially for the rapid-growth phase of a country, it simply cannot cause growth effects without a corresponding increase in capital accumulation. Indeed, the effect noted by researchers above merely postulates a reallocation of labor across sectors (generally agriculture to manufacturing) coupled with technological advances imported from others, which are then supported by capital accumulation as the source of growth. In fact, this viewpoint is exactly the same as standard growth model assumptions: Accumulation of capital, in tandem with technology, to a given labor stock increases the productivity of that stock but with diminishing marginal returns to both the technology (computers cannot run themselves) and the physical capital (even computers in a much bigger room). It is here that the middle income trap occurs, when the marginal returns diminish to zero or near-zero, and another influx of technology coupled with labor upgrading (leading to productivity gains) is required.

Timing, Timing

The second problem related to the MIT is that the definitions for this concept are rarely precise and often depend on the specific observer. For example, Israel is believed (as in the World Bank study) to have graduated from the middle-income club over the past five decades. However, this country had already been on the margin of being high-income: In 1960, its GDP per capita was 46% of that of the US. More importantly for the middle income trap story, Israel's GDP per capita also stagnated through repeated wars and oil embargos (as shown in Figure 5) until the economy underwent a rapid stabilization program in 1985 coupled with intense market-oriented reforms. So while Israel "escaped" the middle income trap, we can not say that the country was very successful in economic growth over most of the period discussed. Indeed, it only reached higher levels of growth relatively recently, which helped to push it over the bar it had already hovered close to.

The example of Botswana, also shown in Figure 5, makes another case for the difficulty of defining MIT. Botswana is widely recognized as

13 Daude, C., & Fernandez-Arias, E. (2010). On the Role of Productivity and Factor Accumulation in Economic Development in Latin America and the Caribbean. Inter-American Development Bank, Research Department. Publication No. 4653.

14 Solimano, A., & Soto, R. (2004). Latin American Economic Growth in the Late 20th. Century: Evidence and Interpretation. Documentos de Trabajo 276, Instituto de Economia. Pontificia Universidad Católica de Chile.

a growth model for developing countries, with GDP per capita that has increased six-fold since its initial tentative steps to growth in the late 1980s. Although the country no longer belongs to the low middle-income group, the large gap between middle-income and high-income countries means that Botswana is to stay in the MIT for decades.

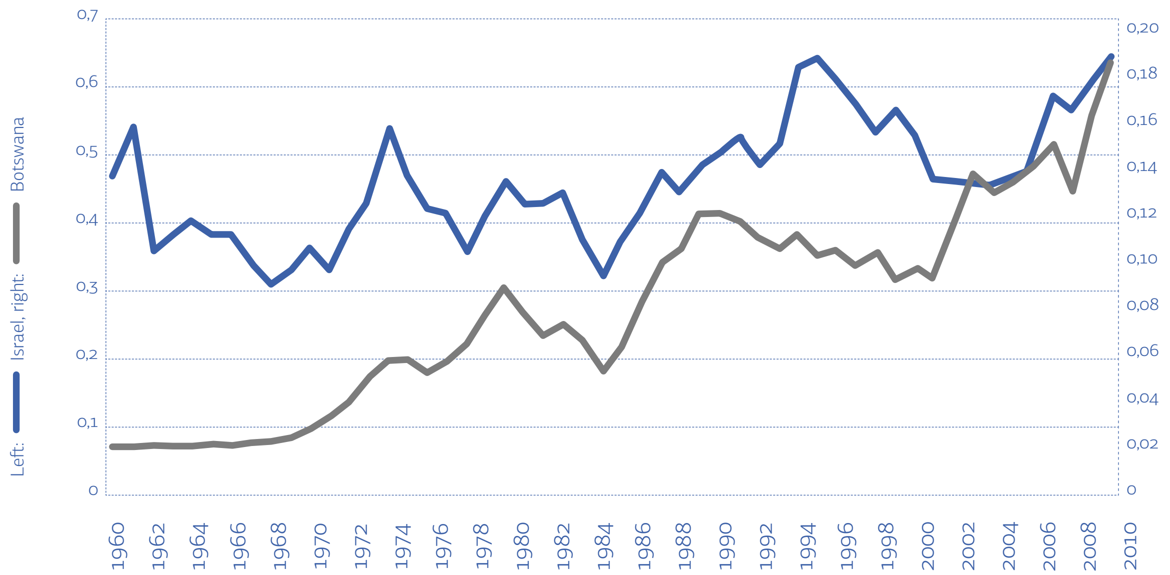
Who Goes into the Trap May be More Predictable than We Think: The Role of Policies

Given that the recent buzz over the middle income trap hinges on its novelty, the comparison with existing theories of economic growth is wounding but not fatal, as are the worries about timing (a semantic issue) and the role of volatility. More difficult to tease out from the middle income trap concept, however, is how the countries that entered into the trap appeared to get stuck there. In this, a look at the case studies and commonalities across the broad swathe of countries in the trap may appear illuminating and show that the trap is not as unique as thought.

Recent economic research has concluded that macroeconomic stability is a necessary (but not sufficient) condition for sustained economic growth and development.[15] While there may be other ingredients in the growth elixir, the base of all growth derives from macroeconomic prudence. Without this stability, the entire economic environment of a country is in turmoil: Expectations are impossible to form in a high inflation environment, resource allocation is distorted, investment is dampened, and time-horizons are shortened considerably, meaning less long-term savings or planning. Moreover, macroeconomic gyrations translate into growth volatility, which is often more deleterious than slow growth; boom-bust cycles only add to uncertainty and create "lost years" as a country climbs out of repeated recessions instead of maintaining an upward growth trajectory.

This, unfortunately, has been the growth trajectory for many emerging markets over the

Figure 5. GDP per capita relative to the US, Israel and Botswana



Source: World Development Indicators

15 See the presentation Growth in the Post Crisis World by Stanford Professor (and Nobel laureate) Michael Spence to the IMF in late 2011. Retrieved December 3, 2012, from: http://www.imf.org/external/np/seminars/eng/2011/res/pdf/MS2presentation.pdf

The other common thread in these periods of macroeconomic stability is that they were all home-grown, that is directly resulting from policies consciously enacted in the particular country and not imposed by outside conditions or actors

past 50 years (and not a constant climb and then plateau, as the MIT literature implies). A look at the growth rate of Israel in Figure 5 shows that it has been neither constant nor consistent, following a rollercoaster-like pattern instead. Additionally, it is clear that not all growth is created equal. Indeed, slow growth can be more sustainable than continuous rapid growth, mainly because if the former is observed after initial stages of capital accumulation, it can be symptomatic of inflated growth (through monetary or fiscal stimulus) rather than of that underpinned by productivity gains. This is especially true if, as several economists have recently proposed in cutting-edge research, it could be lack of growth that is the true "natural" state of an economy, not sustained growth.[16] One can also see, in terms of effects on expectations and investment, a more deleterious effect on an economy from episodes of rapid growth followed by deep contractions: "Start-stop" growth is much more damaging to a country than a longer period of slow, yet consistent one.

The countries that are often cited as examples of the middle-income trap, however, show that even this most basic of economic lessons has been ignored around the world. India, in particular, only saw acceleration of growth when it finally stabilized in 1991, but was unable to build upon these gains until a series of more structural reforms in the 2000s that allowed for capital accumulation. Similarly, the extreme political volatility of Argentina has led it on a decreasing growth path over a hundred-year period, as increasingly concentrated political powers led to concentrated economic power and lurches from one bad policy to another. Indeed, the main reason that economic policy was able to affect the real economy in Argentina so substantially was due to the concentration of political power. Finally, the difficulties inherent in economic transition were a huge macroeconomic shock that, once calmed down, led to growth, but repeated economic troubles (such as the currency crisis in Russia in 1998) and poor economic management (as with Ukraine's government spending and inflationary bonanza) have kept growth in check.

The other common thread in these periods of macroeconomic stability is that they were all home-grown, that is directly resulting from policies consciously enacted in the particular country and not imposed by outside conditions or actors. Of course, a case can be made for emerging markets specifically that some instability can be imported; given their small size on the world stage and the fact that they are mostly price-takers and not price-makers, they can be susceptible to larger macroeconomic conditions. However, it has also been the most open countries that have seen the most consistent growth patterns upward. While trade may not necessarily "create" growth, being a second-order effect of economic activity (there must be investment and production before there is anything to trade), the attitudes toward it are a signal of a government's commitment to free and open economic policies. East Asian countries have been successful in achieving high and sustained rates of economic growth since the early 1960s because of their free-market, outward-oriented economies.[17] Conversely, many of the Latin American coun-

16 Gordon, R. J. (2012). Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds. NBER Working Paper No. 18315 (August).

17 World Bank (1993). The East Asian Miracle: Economic Growth and Public Policy. Oxford: Oxford University Press.

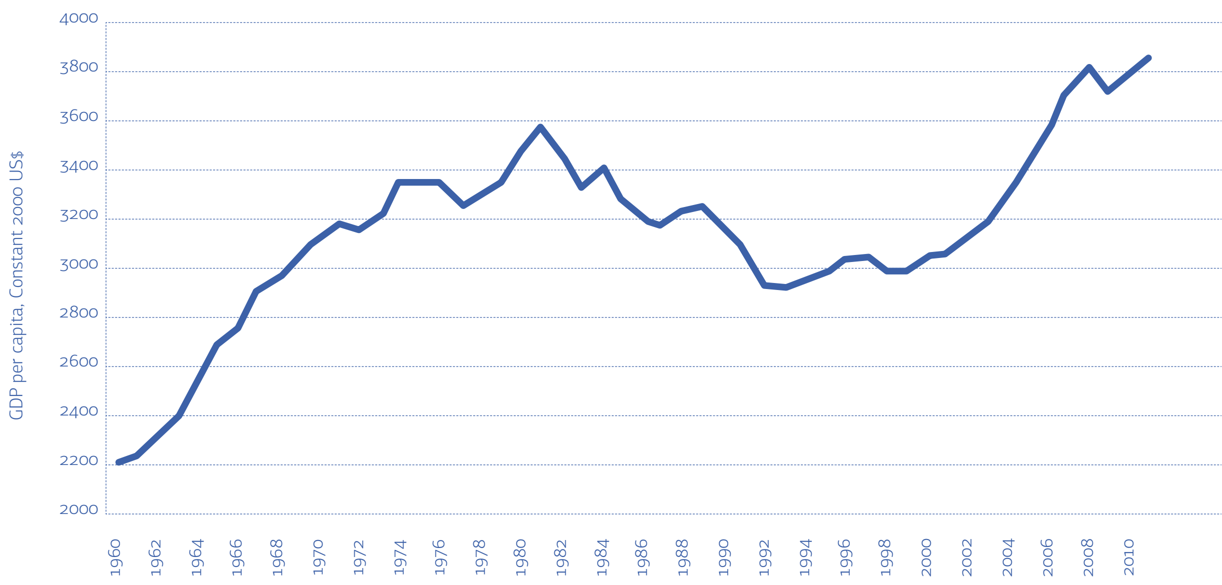
tries that are caught in the middle-income trap adopted import substitution and government-directed industrialization instead, with the example of Argentina showing a clear break in growth before and after it decided to pursue protectionist policies. Due to India's "Fabian socialism" and license regime for any sort of international transaction, the country stayed on an incredibly slow growth path for decades, only seeing an improved trajectory once it began to liberalize its trade. South Africa has also continued to see problems in its own growth due to trade, as the next case study will show.

The Role of Policies: South Africa's Trap of Its Own Making

No region perhaps typifies the tired conceptual problem with the middle income trap than Africa which, admittedly, has mostly been caught in an "underdevelopment trap." As shown in the last section and in the introduction, the region that, on the aggregate, had the worst growth performance over the past 50 years was sub-Saharan Africa. In contrast to East Asia, which had several high-flying performers staggered over the entire period, or Eastern Europe and Central Asia, which saw boom-bust periods, SSA saw only one recognized success story (Botswana) and countless failures. These failures have not just been regular problems of growth slowdowns—they have been spectacular: according to the World Bank, Liberia's per capita GDP in 1996 (in constant US$2000) was a near-invisible $58 ($30 lower than China directly preceding the Cultural Revolution in 1964), while the Democratic Republic of the Congo (DRC) has failed to post a per capita GDP higher than $100 for its entire existence.

However, the raison d'être of the MIT argument is not that some countries grow while others do not; it is that some countries start to grow then stall. Thus, for our purposes, countries that have never grown, such as DRC and Liberia (and, indeed, the vast majority of African countries), are less interesting in regards to the MIT than those that have and no longer do. However, these countries are harder to find in SSA, as most African countries either have not yet attained the US$1,000 per capita GDP threshold, or have

Figure 6. GDP per capita Growth in South Africa, 1960-2011



Source: World Development Indicators

been as (again) Botswana, which has grown by an average of 4.81% since attaining the US$1,000 per capita GDP threshold and 3% since it crossed the MIT threshold of US$3,000 per capita. A better example of the middle income trap is Gabon, which saw its per capita GDP peak in 1976 at $8,594 but declined precipitously over the next ten years to settle in the US$4,300 range (where it has been since 1997). Namibia also meets the criteria, although it reached the "stall" threshold a bit sooner than most: after attaining a per capita GDP of $2,263 in 1980, the country saw its standard of living decline and then slightly rebound, reaching a GDP per capita in 2011 that is merely 21% above its 1980 level.

But it is perhaps Namibia's large and well-known neighbor, South Africa, which has shown the most signs of the middle income trap. As Figure 6 shows, per capita GDP growth in South Africa has been quite variable over the past 50 years, neither falling below US$2,200 nor quite reaching US$4,000. After impressive gains into the early 1980s, growth tapered off and then receded as international sanctions on the apartheid regime increased. Growth haltingly resumed after apartheid's fall in 1994, but per capita GDP only reached 1981 levels by 2006; moreover, the overall state of the economy had taken a turn for the worse, with a worryingly high unemployment rate that continues to be among the highest in the world (fluctuating between 25% and 32% from 2000 to 2012).

The reasons for this growth slowdown were attributed by Dani Rodrik in 2006 to a decline in the relative profitability of manufacturing in the country throughout the 1990s,[18] although other observers have noted that the persistent unemployment is due to the power of unions in the South African economy (and their wage-setting power far above market-clearing rates). An IMF examination from 2009, using both a GDP and a growth accounting framework, notes that the real culprit has been sluggish investment: "The difference in TFP (including fewer skills)… seems to explain part of the growth gap, but it is less striking than the gap in investment."[19]

Of course, all of these explanations are probably true to some extent and more a question of sequencing than anything else: Manufacturing would be less profitable due to union power, and a sector in decline would be less likely to attract much investment. However, these explanations miss a key issue in South Africa's growth, and that was that the country itself retained a lot of its sanctions after the international community had let them go; that is, while in 1994, the country underwent a series of trade liberalization reforms, it never went all the way in liberalizing. As of 2009, the country's average tariff rate was still twice the European Union's, with the tariff structure distributed throughout the economy and few goods spared (a study from 2011 noted that "the ten most protected goods are quite low-tech in nature").[20] Similarly, administrative delays and bureaucracy at the border are epidemic in South Africa, as the country is ranked 115 (out of 183) in the 2013 World Bank Doing Business "trading across borders" sub-category.[21] It appears that South Africa took its protectionism as exogenously determined and still has yet to rid itself of the chains imposed upon it by the world during the days of apartheid. Indeed, in many ways, it has embraced it.

18 Rodrik, D. (2006). Understanding South Africa's Economic Puzzles. Prepared for the Harvard University Center for International Development Project on South Africa. Retrieved November 23, 2012, from: http://www.hks.harvard.edu/fs/drodrik/Research%20papers/Understanding%20South%20Africa.pdf.

19 Eyraud, L. (2009). Why Isn't South Africa Growing Faster? A Comparative Approach. IMF Working Paper WP/09/25, p. 8.

20 Freytag, A. (2011). Cumulative Costs of Trade Protection in the South African Economy. South African Institute of International Affairs (SAIIA) Occasional Paper No. 80. Retrieved November 29, 2012, from: http://www.saiia.org.za/images/stories/pubs/occasional_papers/saia_sop_80_freytag_20110301.pdf.

21 Interestingly, this is a huge jump for South Africa, which was ranked 145th in the world in 2012. Regardless, there is still a long way to go to reduce governmental intrusion into commerce.

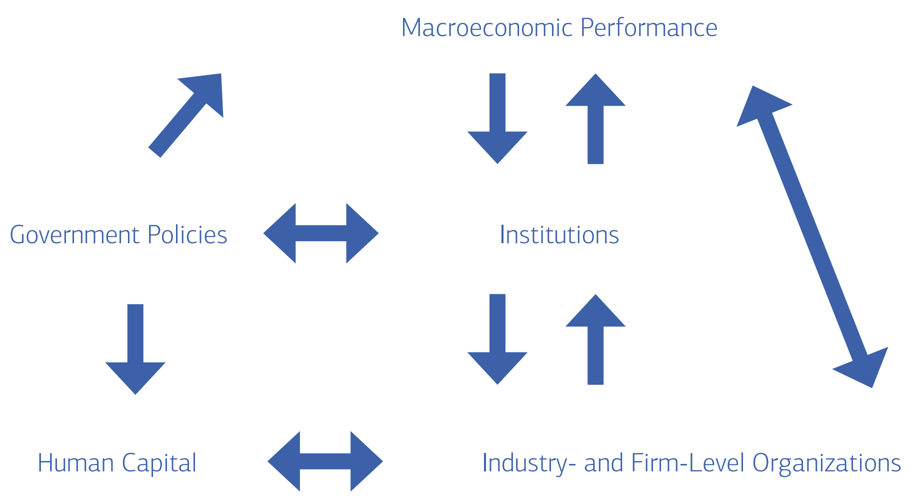
III. Institutional Development: The Missing Key

The key intermediary that can help to explain the slowdown of growth is poor institutions

Given the lack of uniqueness of the countries involved in the middle income trap, the last reason in our critique of this concept is all the more relevant: Why does a country get trapped that is distinct from bad policy? Current theories focus on diminishing technological transfer (the fact that one can only free ride off of the developed world's technology for so long) or a shrinking pool of "surplus" labor that leads to excess demand, wage growth, and, inevitably, a loss of labor-cost competitiveness.[22] The World Bank has also modeled this phenomenon and surmised that there are "network effects" that require a certain mass of people to be in a profession before it can take off (e.g., having the first telephone is still quite useless until other people also acquire them); thus, a country might be caught in a trap where highly educated and skilled workers have talent going to waste because the critical mass has not been reached yet.[23]

However, these current explanations are very micro-oriented in that they focus on industry-specific issues that may miss the bigger issues surrounding growth slowdowns. Besides that, as we just explored in the previous section, there are indeed macroeconomic issues that lead to macroeconomic problems (as in the role of bad policies), but they too may not capture the whole picture of how a growth slowdown may occur; many countries have had macroeconomic stability and yet still not seen a growth take-off. In our estimation, the missing ingredient in the growth elixir, missing especially from the middle income trap concept, is a much simpler "mezzanine issue" with components

Figure 7. Mezzanine Factors of Growth



Source: World Development Indicators

22 Canuto, O. (2011). Navigating the Road to Riches. Retrieved November 27, 2012, from: http://www.project-syndicate.org/commentary/navigating-the-road-to-riches#IeB8l5zHh1q5Upfg.99.

23 Agénor, P., and Canuto. O. (2012). Middle Income Growth Traps. World Bank Policy Research Working Paper 6210.

of the national economy that mediate and influence both its macroeconomic and microeconomic facets. The key intermediary that can help to explain the slowdown of growth is poor institutions, an issue that can negatively impact growth if they are absent or poorly utilized (see Figure 7). This section will examine the effects of this "mezzanine factor" in promoting growth, with reference to the growth paths of specific emerging markets.

The relation of the size of government to growth has been almost uniformly a leading indicator of stagnation

Institutions: Incentives, Facilitation, and Creating the Resources that Do Not Yet Exist

Relatively neglected as a source of economic outcomes for much of the 20th century, many economists working on development and transition have come to the conclusion that institutions—which shape the incentives of a society—are the fundamental determinant of economic performance and long-run growth in a country. Under this research thread, a country will have dynamic growth and become rich if it has good institutions, which provide incentives for work, accumulate human and physical capital, acquire better technology and improve resource allocation.[24] This is another variant of standard growth model arguments—capital accumulation (or total factor productivity) can take you so far, but without the proper institutions to provide proper incentives, diminishing marginal returns set in sooner rather than later.

This approach can be further broken down into a proper delineation of institutions, although the growth literature rarely does this. This is crucial, as different institutions have different goals; for example, political institutions tend to be concerned more with distribution of power, while economic institutions focus on the distribution of production and resources in society. It is these distinctions that also condition the effects of institutions on emerging markets. In particular, three specific institutions have the most salience in the middle income trap debate for their effect on growth: the size of government, political volatility, and the expansion of economic freedom.

Feeding Leviathan

One of the most basic institutions in a country is its government, and the size of government often encapsulates societal views towards the proper role of government vis a vis the private sector. The relation of the size of government to growth has been almost uniformly a leading indicator of stagnation (and, more generally, of crises); Figure 8 shows the trends in government growth in some key emerging markets, and while the growth of government is not constant, in many cases, it is only macroeconomic or financial crises that immediately stunts the growth of Leviathan. Russia is one of the few countries that have seen multiple episodes of government contraction, again due mainly to crises, while countries such as India have seen explosive episodes of government (notably during the period it was supposedly liberalizing in the 1990s).

Of course, the definitional issue of how one calculates "growth" rears its head here: As government spending is one component of GDP, of course any contraction in spending will result in a lowering of GDP, all other things being held equal. However, this accounting issue overlooks the reality of higher government spending, especially in emerging markets, which crowds out private investment and can distort incentives (as well as create corruption and rent-seeking opportunities). Moreover, the supposed benefits of government spending in

24 See, for example, Acemoglu, D., Johnson, S., & Robinson, J.A. (2005). Institutions as the Fundamental Cause of Long-Run Growth. In Aghion and Durlauf (eds.), Handbook of Economic Growth: Volume 1A, North Holland: Elsevier, 385–472.

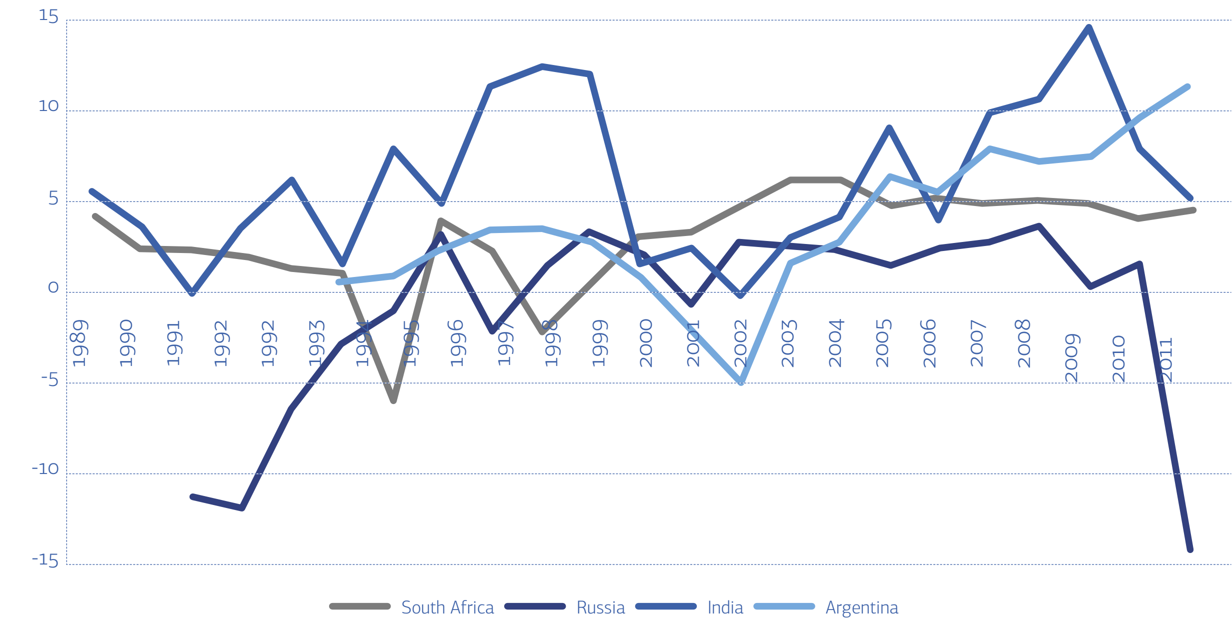
clearing bottlenecks in the development process of emerging markets (such as creating infrastructure) have also not been addressed, despite the continual growth of government in these stagnant economies. Simply put, a large part of any development trap, whether at the low, middle, or high-income level, is that government has grown too much for the economy that exists. This then acts as a drag on the economy that might exist in the future.

Political Instability: Expectations and the Case of Argentina

Not only is the level of government a determinant for growth, but the volatility of government can also have a major impact on a country's growth path. Political instability as noted here, however, is not necessarily like that of Italy, in that governments come and go all the time; moreover, political instability can also be applied to one-party rule (as in Russia) if there is enough variation due to the personalities of those involved. This "economic uncertainty" would then translate through all levels of the economy.[25]

Argentina is a prime example of political instability having deleterious effects on growth through direct effects (sudden reversals of policy) but also through the indirect effects of expectation formation and, in the more corrupt societies, rebuilding of networks necessary to get things done. Latin America has been held up as the region that has been most afflicted by the middle income trap, mainly due to the travails of the two largest economies in the region. Indeed, comparison with East Asia's success story is the cornerstone of the MIT literature: Figure 9 shows the growth pattern for two East Asian (Singapore and South Korea) and two Latin American (Chile and Mexico) economies, where we can see that Singapore's and Korea's growth

Figure 8. Government Growth in Selected Countries, 1989-2011



Source: World Development Indicators

25 Baker, S.R., Bloom, N., and Davis, S. (2011). Measuring Economic Policy Uncertainty. Retrieved November 19, 2012, from: http://leeds-faculty.colorado.edu/bhagat/PolicyUncertainty-davis.pdf.

rates are much higher than Chile's and Mexico's at every development stage. Figure 10 also shows the variability in growth in Latin America, with even the highest-flying performers failing to match the impressive growth in the Asian "tigers."

Political instability is a manifestation of weakness in political institutions, but other, explicitly economic institutions are necessary for sustained growth

While Brazil has seen its own share of policy problems and growth issues (it reached the US$3,000 per capita mark in 1976 and has only just grown to $4,803 in 2011), it is its large neighbor and rival that is perhaps the poster child for growth slowdowns. By any metric, Argentina's experience of rollercoaster growth and contraction typifies the middle income trap: In fact, Argentina is even more interesting as it is the only country in the world that had been classified as "developed" in 1900 and was downgraded to "developing" by 2000 (again perhaps suggesting that Argentina's problem is not so much a "slowdown" as a reversal).

Throughout the period 1896–2010, Argentina saw external shocks and changing world economic conditions, but also a preponderance of internal turmoil, that, as documented by Nauro Campos and Menelaos Karanasos, had severe negative economic effects due to its formal and informal political instability, as well as its propensity to introduce horrific economic policies.[26] The rise to power of the military junta in the 1930s corresponded with the beginnings of decline of the Argentine economy, and the election of Juan Peron in 1946 led to an entirely misguided emphasis on "import substitution" policies and a repudiation of the export-led growth model which had guided Argentina to prosperity in the early 20th century. Indeed, "Peronism," a similar model to that being practiced around the world at the time, heavily increased the state's intervention in the economy and introduced every macroeconomic policy that has failed: price controls, wage controls, exchange controls, nationalization, and increasing protectionism.

The poor performance of Argentina led to a recurring cycle of revolution and coups, with Peron ousted in 1955 and succeeded by a president who continued his attempts at economic self-sufficiency for the country. President Arturo Frondizi was himself ousted in a coup in 1966, and most economic policies continued, apart from some de-nationalization of important industries. While this token attempt to move away from central planning increased growth rates in the country, it coincided with a huge ramp-up in "quantitative easing," as the Central Bank of Argentina (under the guidance of Peron's latest government—he had been reelected in 1973) began to run the printing presses as a means to finance growing government spending.[27] Coupled with a government-directed price increase named the "Rodrigazo" after the Economy Minister (which included wage hikes, devaluation of the currency, and fuel and utility price hikes), hyperinflation decimated the economy from 1975–1991 (with annualized rates of 300% per year).[28] It was not until free-market reforms of 1991 that the back of inflation was finally broken and growth began to return (Figure 11).[29]

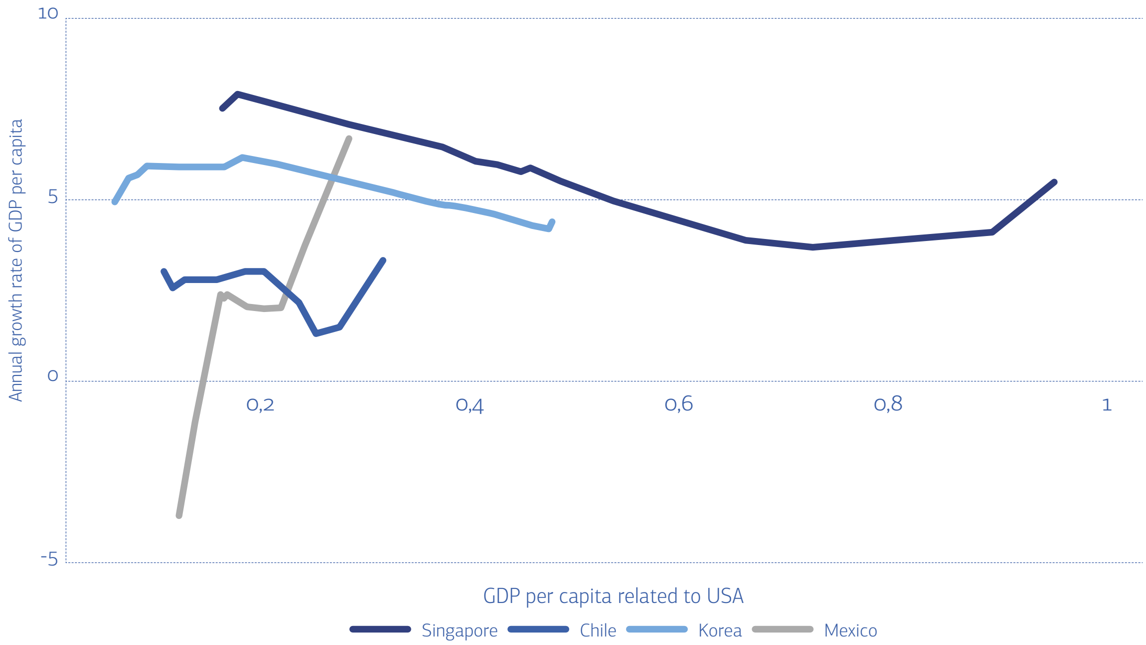
26 Campos, N. F. & Karanasos, M. G. (2008). Growth, Volatility and Political Instability: Non-Linear Time-Series Evidence for Argentina, 1896-2000. Economics Letters, 100(1), 135 –137.

27 Marie, J. (2010).Inflation in Argentina during the Second Peronist Period (1973-76): A Post-Keynesian Interpretation. Review of Political Economy, 22(2), 281–299.

28 Schuler, K. (2005). La economía argentina en la segunda mitad del siglo XX (Review). Economic History Services. Retrieved November 28, 2012, from: http://www.webcitation.org/63vt5FBlB.

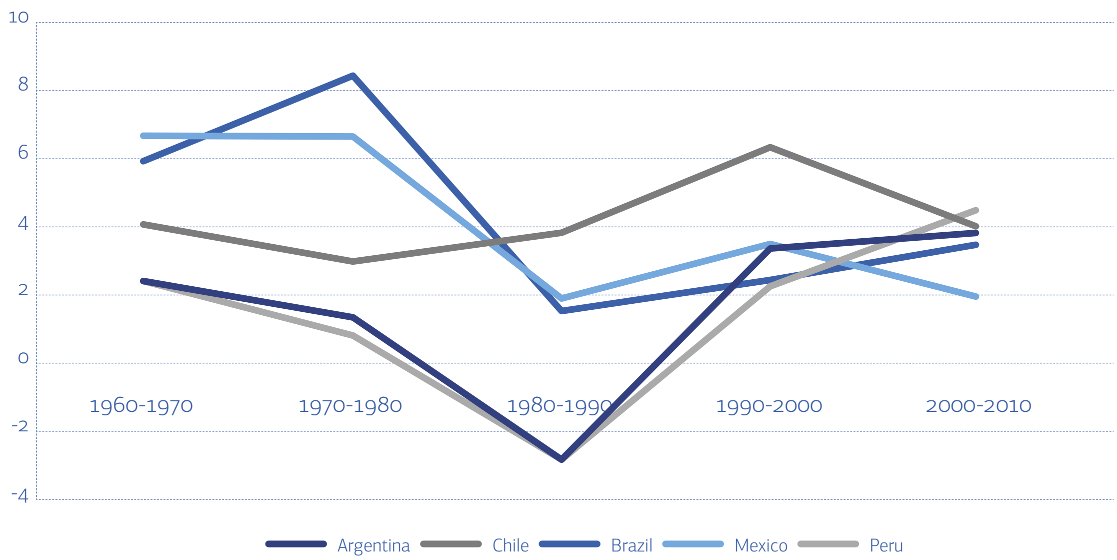
29 Pou, P. (2000). Argentina's Structural Reforms of the 1990s. Finance & Development, 37(1). Retrieved November 28, 2012, from: http://www.imf.org/external/pubs/ft/fandd/2000/03/pou.htm.

Figure 9. Asia v. Latin America, Growth Levels and Rates



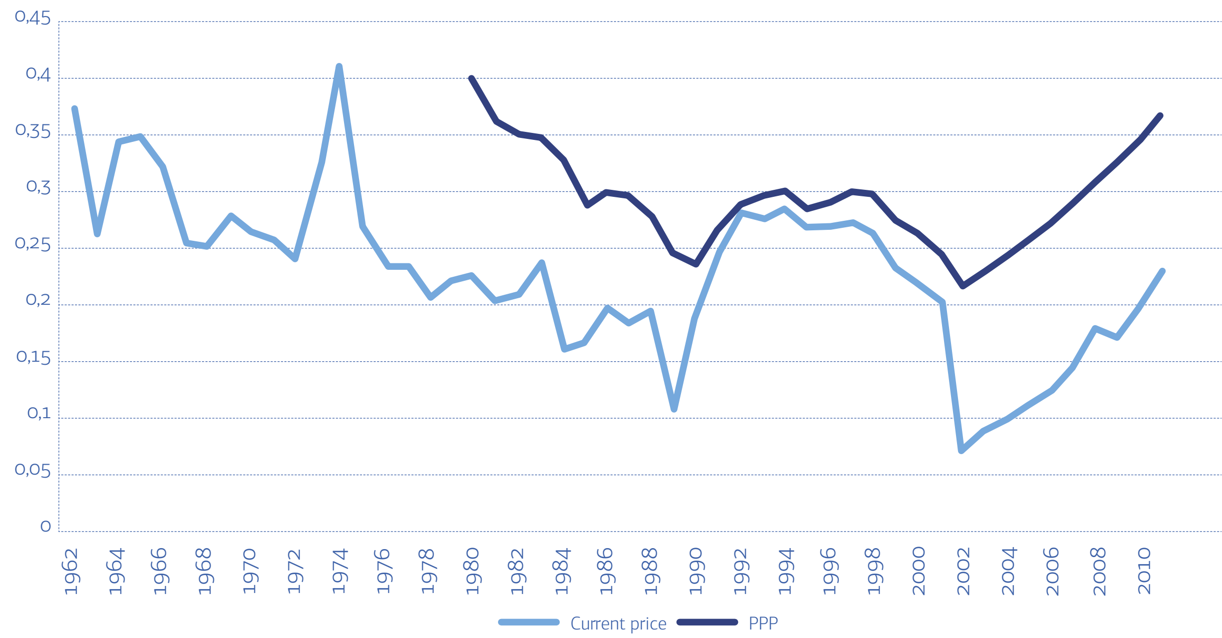
Source: World Development Indicators

Figure 10. Growth Rates in Latin American Countries



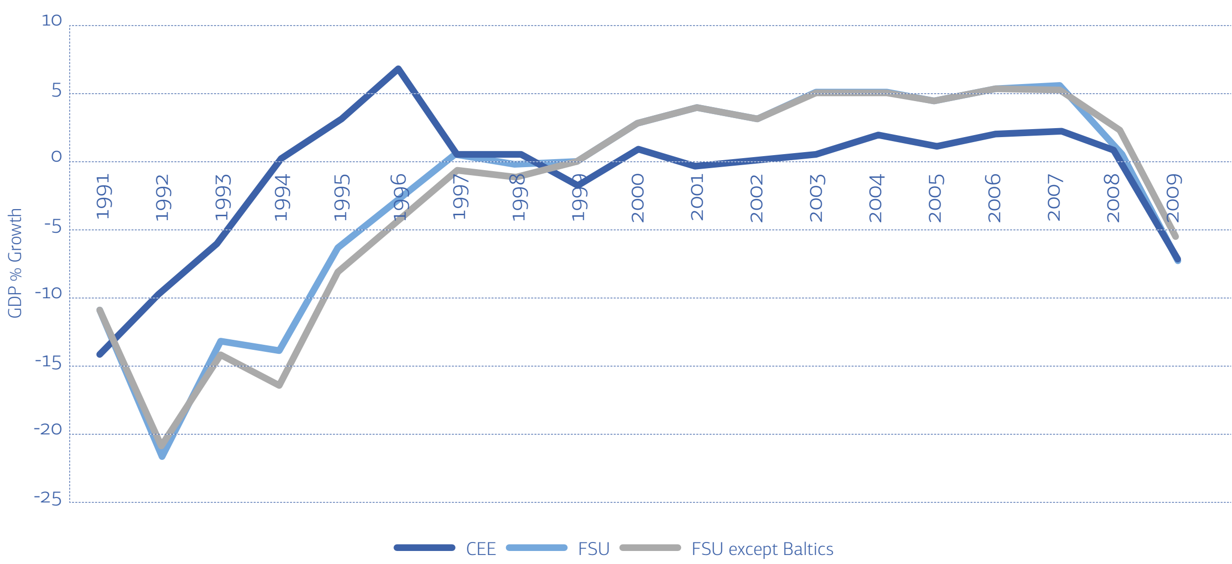
Source: World Development Indicators

Figure 11. GDP per capita relative to the US: Argentina



Source: World Development Indicators

Figure 12. Growth in Transition Economies



Source: World Development Indicators; Author's calculations

There has been a substantial divergence between the countries of Central and Eastern Europe (CEE) and those that actually were a part of the Soviet Union in growth paths

However, Argentina today remains on a drift downward: Financial crisis in 2002, brought on not only by adverse international conditions, but also by a huge increase in government spending, threatened the banking sector of the country and led to severe effects on the real economy. Perhaps more worrisome, but keeping with the tradition in Argentina of a crisis never being so severe that government intervention cannot make it worse, the government of Cristina Kirchner started another series of reforms in 2007 to hide the real state of the economy, including doctoring official inflation statistics. President Kirchner compounded this subterfuge with steps to allow the central government access to central bank reserves, increased import restrictions, and imposed draconian laws that force banks to report every credit card purchase to the tax authorities.[30] As of this writing, and although with a stellar growth rate near 9% (officially) in 2011, Argentina faces another collapse brought on by government mismanagement of the economy. The experience of Argentina leads us to believe that the country may one day escape the middle income trap—however, its trajectory over the past hundred years (accelerating in the past three) suggests it will escape only by falling to a lower income country, rather than becoming high-income.

Economic Freedom: A Transition to Growth?

Political instability is a manifestation of weakness in political institutions, but other, explicitly economic institutions are necessary for sustained growth. In the economic literature, the importance of "good" institutions for growth has been widely recognized indeed: These fundamental goals of creating correct incentives are what makes an institution "good," and one of the key institutions that comes under the heading of "good" is the broad-based institution of economic freedom.

The former communist countries of Central and Eastern Europe and the former Soviet Union are perhaps the states with the most interesting growth paths—paths that show the importance of proper institutions. With the fall of the Soviet Union at the end of 1991, a wave of hope surged throughout the region that growth and democratization would be soon forthcoming. With the hindsight of 20 years of independence, however, while both occurred in Central and Eastern Europe, the reality is that neither really occurred in the Central Asian successor states. Indeed, it is questionable if the Central Asian states "transitioned" at all economically or politically, given that 3 of the 5 states (Kazakhstan, Uzbekistan, Tajikistan) have the same leader they had during the last days of the Soviet Union or first days of independence, and the other two have seen two coups (Kyrgyzstan) and a cult of personality to rival that of Stalin or Mao (Turkmenistan). In reality, much of Central Asia has moved to independence but not really "transitioned."

This does not mean that there has not been growth, although the Soviet apparatus has been dismantled in some countries more than in others. As just noted, there has been a substantial divergence between the countries of Central and Eastern Europe (CEE) and those that actually were a part of the Soviet Union in growth paths: As Figure 12 shows, the CEE countries recovered earlier in terms of absolute GDP growth from their transformational recession (in the words of Janos Kornai) and grew faster

30 Matonis, J. (2012). Argentina Begins Tracking All Credit Cards. Forbes. Retrieved November 28, 2012, from: http://www.forbes.com/sites/jonmatonis/2012/09/04/argentina-begins-tracking-all-credit-cards/.

afterwards than the former Soviet Union (FSU) in the first decade of transition.[31] As several authors have noted, the recovery in CEE was due mainly to their more advanced institutions, as well as the advancement of policy reforms that was much farther along than in the CIS countries (as well as the comparatively smaller extent of heavy industrialization that characterized the Soviet Union and its republics).[32] The takeoff of growth in the FSU from 2000 onward was puzzling, however, even when accounting for the energy sectors—mainly because the FSU did not see the same sort of institutional advancement that the CEE countries did. [33] The reason for this may be attributable, as researcher Oleh Havrylyshyn notes, to the fact that by 2000, the FSU countries had achieved the same level of institutional development as the CEE countries had before transition began (see Table 1); thus, a "minimum threshold" was reached that allowed for the fast-growth portion of their journey to begin.[34] This is consistent with India's experience mentioned above, where an economy that was so riddled with distortions that it had incredible marginal gains upon finally seeing a loosening up of restrictions, even without the institutions necessary to reach sustained growth.

In terms of the institutional development in the FSU, in many countries only a bare minimum of important economic institutions is in place. For example, the most important economic institution of all, property rights, has shown remarkable resilience against improvement: According to the Heritage Foundation's sub-index of property rights, on a scale of 1 to 100 (with higher numbers indicating better protection of property rights), the highest non-Baltic former Soviet republic is Armenia, with a score of 35. Moreover, not only have property rights not been protected, their status has worsened in the FSU over the past ten years (Figure 13). Coupled with this decline in basic property rights has been stasis in many other institutions, including the development of an independent judiciary and basic labor market institutions. By nearly every institutional metric, the countries of the former Soviet Union score lower than the countries of Central and Eastern Europe, with only the Baltic countries the exception.

Table 1. Heritage Index of Economic Freedom Scores, CEE in 1995 v. FSU in 2000

1995		2000	
Romania	42,85	Turkmenistan	37,60
Albania	49,68	Uzbekistan	38,13
Bulgaria	50,03	Belarus	41,29
Poland	50,70	Tajikistan	44,83
Hungary	55,22	Ukraine	47,81
Slovakia	60,36	Azerbaijan	49,83
Estonia	65,25	Kazakhstan	50,35
Czech Republic	67,79	Russia	51,84
		Georgia	54,34
		Kyrgyzstan	55,70
		Moldova	59,57
		Armenia	63,03

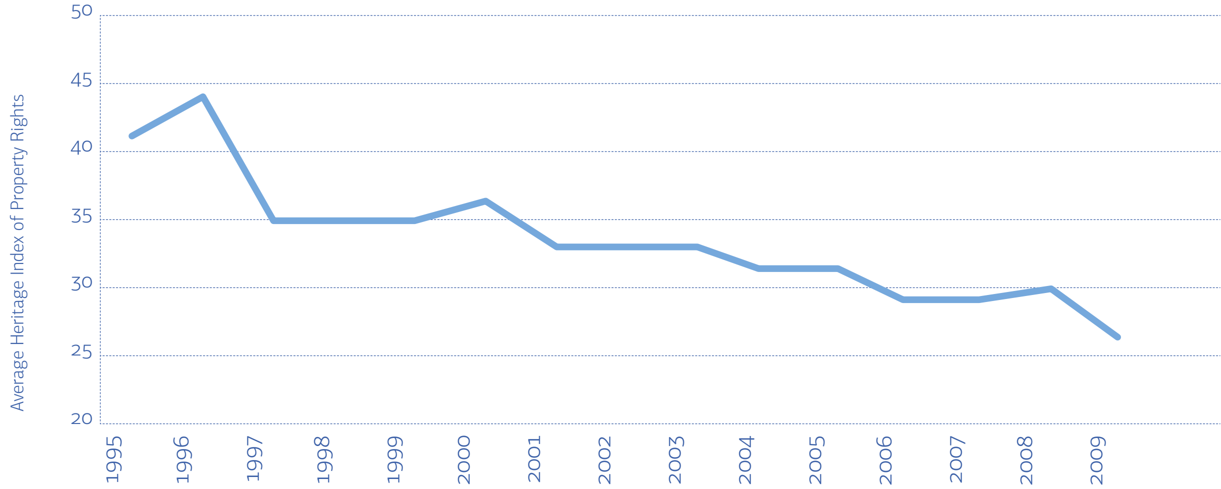
31 Kornai, J. (1994). Transformational Recession: The Main Causes. Journal of Comparative Economics, 19(1), 39-63.

32 For a comprehensive treatment of institutions in transition economies, see Hartwell, C.A. (forthcoming), Institutional Barriers in the Transition to Market: Explaining Performance and Divergence in Transition Economies, Basingstoke: Palgrave Macmillan.

33 Havrylyshyn, O. (2008). Growth Recovery in CIS Countries: The Sufficient Minimum Threshold of Reforms. Comparative Economic Studies, 50, 53–78.

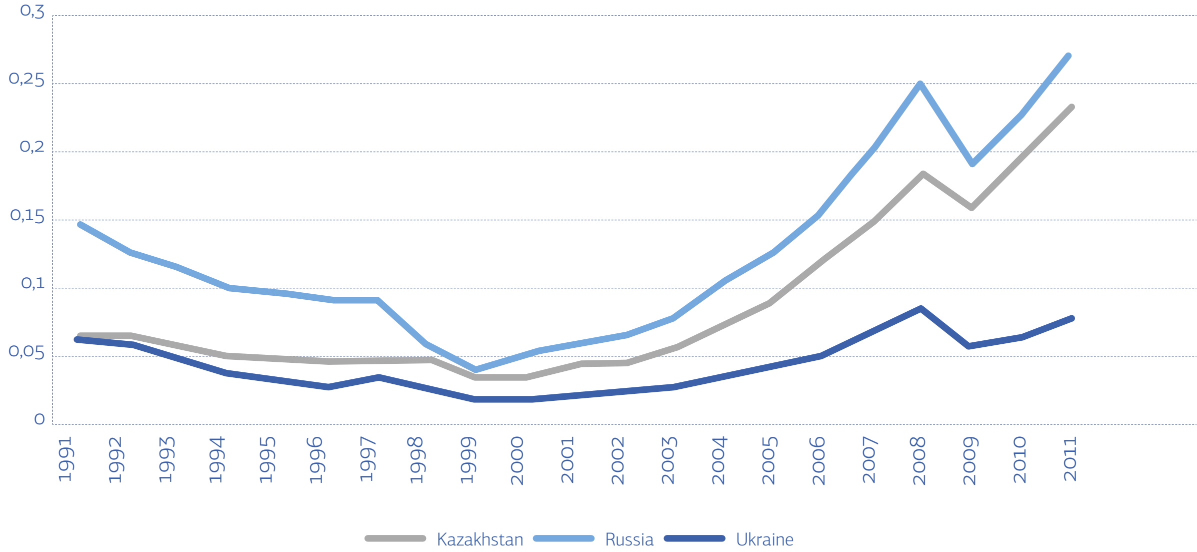
34 Ibid.

Figure 13. Decreasing Property Rights in the FSU



Source: Heritage Index of Property Rights, Author's calculations

Figure 14. GDP Per Capita Relative to the US



Source: World Development Indicators

IV. Conclusions and Recommendations

This study has attempted to take a deeper look at the "middle-income trap," note the issues with its current formulation, and, more importantly, isolate commonalities across countries that have stalled in their growth. From the analysis presented in the previous sections, two major recommendations can be distilled for emerging market countries:

- *The Fundamentals Still Matter*

Macroeconomic stability may not be sufficient to prevent a growth slowdown, but just because some level of growth has been achieved, it does not mean it is time to throw out macroeconomic stability as a policy goal. Simply put, macroeconomic stability is necessary at all levels of development, and governments are advised to keep their eyes on maintaining macroeconomic stability (especially in regards to inflation) at all times. Even growth that has been achieved can be wiped out by just one experience of high levels of inflation, and thus, in order to avoid the middle-income trap, macroeconomic stability (including fiscal prudence) must be adhered to. This includes avoiding inflationary temptations (unlike Argentina, Turkey, and other countries that have fallen into the trap), while keeping the overall size of government low (as in Poland and Estonia).

This recommendation is even more crucial given the experience of developed countries during and following the global financial crisis, where it appeared that the "old rules did not apply," and stimulus spending was injected without a thought as to the consequences in inflation, asset bubbles, and fiscal prudence. With continued sluggish growth in the OECD (led by the United States, which has an open-ended fiscal and monetary commitment to growth stabilization, if not macroeconomic stabilization), the dangers of macroeconomic instability are even more pronounced. Emerging markets, which do not generally have the luxury of a market of more than 300 million or attractiveness to Chinese investors, would be cautioned to avoid the policy moves currently on display in the developed countries; perhaps emulating the OECD countries would be the easiest way to make an emerging market fragile, and thus more prone to being stuck in the middle-income trap.

Additionally, while the jury is still out in the economics literature on the relationship of openness to trade and economic growth, and if "export-led growth" is a cause or merely a correlate of a healthy economy, there is an undeniable correlation between poor economic performance and trade restrictions. This is mainly because a) trade restrictions shrink the market for producers in a particular country to the domestic market, b) restrictions often bring a whole host of other distortions with them (including the creation of trade-licensing bureaucracies and corruption), and c) a country that closes itself off to trade often pursues other growth-dampening policies as well (that is, trade restrictions are rarely the only distortion a government imposes). South Africa remains a powerful example of this, as do most of the countries of the former Soviet Union.

Moreover, openness to trade is a trait that is crucial to escaping the middle-income trap. As many of the theoretical justifications for the middle income trap note, the first stage of a country's development relies on basic manufactures and reverse engineering, importing existing technology and adapting it so that countries may escape being low-income. To set this in motion, a country must necessarily be open to trade to acquire the basic technologies. However, openness to trade only grows more important as a country develops; as diminishing returns to technology set in, the World Bank's overlapping generations model shows that a critical mass is required (but never reached) to draw highly-skilled workers into higher-skilled manufacturing. Openness to trade could provide this demand that is missing in the home country market, contributing to creating the critical mass to reorient a country's labor force towards higher skills (and, with it, provide sustainable technological growth). Thus, closing off a country behind protectionist walls means cutting off a country's economy from potential consumers that can drive growth.

- *Institutions are Necessary... Political AND Economic*

A key thread running through our examination of growth slowdowns in the last chapter was the extent of institutional development and how institutions evolve. In the first instance, the growth of government is often a sign that a growth slowdown is imminent; that is, government tends to grow as an economy grows (there is more of a pie to distribute, and government services are demanded by richer citizens), but this same growth often leads to crowding out of private investment and a diminution of the same entrepreneurial spirit that sparked growth in the first place. India is an important example of this phenomenon, as its first tentative steps towards liberalization in the 1990s were strangled in the cradle by a concurrent burst of government growth. Its only sustainable growth path occurred once government contracted in the late 1990s, and even then it resumed growth in the mid-2000s, leading to the stalled economic growth the country sees today.

This reality of resource dependence and minor institutional change may provide the key for the past and future of growth in the Commonwealth of Independent States

Beyond merely the size of government are the institutions that make up the government. Political institutions are rarely noticed, except for the times when they fall apart, but when that occurs, they often take whole economies with them. Even in developed, (relatively) mature countries such as the United States, repeated brinksmanship by the executive branch or even routine elections where one candidate espouses deleterious policies can have economic effects (witness the downgrading of US debt by Standard & Poor's in 2011). In many of the emerging markets we have examined, as well as in countless ones that we have not discussed for reasons of space, political instability has served as a continuous drag on growth. Argentina is the most prominent example, where continued political vacillations have created an atmosphere of uncertainty and the impossibility of long-term investments. This problem has been writ large in the sub-Saharan African nations, which have seen political changes lead to incredibly large economic shifts in a short time span (the expropriation policies of Robert Mugabe in Zimbabwe stand out as one of the prime examples). Thus, as part of a pro-growth package of reforms, countries should strive to construct or solidify political environments that are routine, predictable, and constrained by checks and balances. Policymakers, if they truly wish to help their countries to grow, should be prepared to pursue prudent policies but also to step aside if the polity demands it.

Similarly, policies that encourage the growth of market-oriented economic institutions should be pursued. This list definitely includes property rights, judicial independence, and labor market flexibility, as well as business environment reforms that can help these institutions to emerge and thrive. As shown in our examination of the FSU transition economies, many of these crucial "good" economic institutions are still lacking, with property rights being the most important. In other countries, such as Argentina and Russia, it is judicial independence that is lacking, while still other countries have seen institutional development, but only of "bad" institutions. A key example of this is the power of labor unions in South Africa, which has created labor market rigidities that stymied the internal reallocation of labor needed to respond flexibly to changing market conditions. Other countries, urged on by economists such as Joseph Stiglitz, have also focused on "bad" institutions that do not contribute to growth, such as tax administration, at the exclusion of other expenditures that could have aided growth.

We believe that if a country's government focuses on these simple prescriptions, the middle-income trap will one day be irrelevant to the study of economic growth.

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Moscow School of Management SKOLKOVO
Novaya ul. 100, Skolkovo village, Odintsovsky district, Moscow region, Russia, 143025
Phone.: +7 495 580 30 03
Fax: +7 495 994 46 68
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IEMS Beijing
Unit 1608 North Star Times Tower
No. 8 Beichendong Rd., Chaoyang
Beijing, China 100101
Phone: +86 10 6498 1634, Fax: +86 10 6498 1634 (#208)

IEMS Moscow
Moscow School of Management SKOLKOVO
Novaya ul. 100, Skolkovo village, Odintsovsky district
Moscow region, Russia, 143025
tel: +7 495 580 30 03, fax: +7 495 994 46 68

E-mail: iems@skolkovo.ru
Website: www.iems.skolkovo.ru