

Interview with Jay K. Rosengard, Professor of Harvard Kennedy School, Ash Center for Democratic Governance and Innovation

Can Asian Kittens Escape the Middle-Income Trap?

By Japan SPOTLIGHT

As global economic prosperity increasingly depends upon supply, structural reform has become a key variable in enhancing growth potential in the pursuit of economic success. Today, the advancement of some Asian economies seems to have reached a point of stagnancy, falling into the so-called middle-income trap. Economic prosperity is thus determined by whether or not countries in Asia, for example, can escape this trap. What strategies can Asian economies in the middle-income trap implement in order to enhance their growth potential? Professor Jay K. Rosengard, a distinguished expert on the Asian economy at the Harvard Kennedy School, has worked on the issue for more than 40 years and shares his insights on how Asia can overcome the middle-income trap. In the following interview he highlights good governance, infrastructure, technology, human resources and other factors as essential to progress.

What Is the Middle Income Trap?

JS: First, I would like to confirm with you the definition of the “middle-income trap”. The middle-income trap defines low-income Asian countries, for example, that experience challenges catching up to high-income Asian countries. This is due to some time lag in structural reforms, a lack of policy efforts, or some such variable. Is this the basic idea?

Rosengard: Yes. The idea is basically correct. It is not a trap in the sense that it is something beyond their control; it is exactly as you said: the result of maybe a combination of policy decisions they have made and some external factors that might make it more challenging.

JS: To be more specific, in my understanding, high-income countries are seen as the tigers whereas low-income countries are called the kittens. Could you please distinguish between these high-income and low-income countries?

Rosengard: Certainly. Referring to the [Table](#) and [Chart 1](#), you can note that over half of the countries in the world are middle-income countries. For example, Vietnam, the Philippines, and Indonesia in particular are lower middle-income countries but they are striving to



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become upper-middle income, while Thailand and Malaysia are upper-middle income countries trying to become high-income.

Effect of Governance Structure on Economic Development

JS: There are certainly policies that create differences between the tigers and the kittens. Governance structure, in particular, is the principal issue. What would be the most effective way of implementing new development policies, both horizontally and vertically, to get things done?

Rosengard: Let's look at Indonesia as an example. One issue of policy governance is basically for horizontal cooperation between the executive branch, the president, and the parliament. Oftentimes legislators block the executive branch. Conversely, the cabinet represents the distribution of power in parliament. Essentially what you are trying to do is to get some kind of coordination and cooperation horizontally between the executive and the legislative branches. And then vertically, because Indonesia has a major decentralization program, a lot of the policies are actually implemented by local government, by the cities, and by the districts. In fact, a lot of the budget is transferred now to local governments. If you take the grant transfer program, tax sharing, and some other things, about 37% of the national budget goes to the local governments.

TABLE

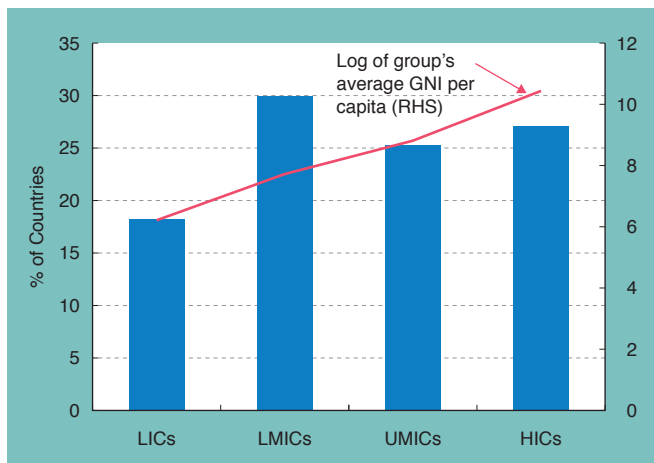
What is middle income?

- Based on estimates of gross national income (GNI) per capita using the World Bank Atlas Method
- Latest classifications as of July 1, 2015 (2014 data):
 - Low income: ≤ \$1,045
→ Cambodia
 - Lower middle income: > \$1,045 but ≤ \$4,125
→ Myanmar, Laos, **Vietnam, Philippines, Indonesia**
 - Upper middle income: > \$4,125 but ≤ \$12,735
→ **Thailand, Malaysia**
 - High income: > \$12,735
→ Brunei, Singapore

Source: Compiled by the author

CHART 1

Distribution of countries (GNI/capita, 2010)



Source: World Development Indicators

So when we talk about coordination, horizontal cooperation is between branches of government and vertical cooperation is between central and local governments. The operation entails planning, financing, and the delivery of basic public goods and services. It's an issue of governance and it's politics. Because in the end, economists know what has to be done but it is the issue of politics and institutional capacity, otherwise known as governance, that can achieve the goal envisaged by the economists.

I like to label it as the question of hard infrastructure and soft infrastructure. [Chart 2](#) and [Chart 3](#) depict the shortage of the Association of Southeast Asian Nations (ASEAN) infrastructure stock, hard infrastructure, and the slow progress of the level of governance indicators among these countries, otherwise known as soft infrastructure. What we are really talking about here is soft infrastructure. It is government and governance and institution capacity to deliver.

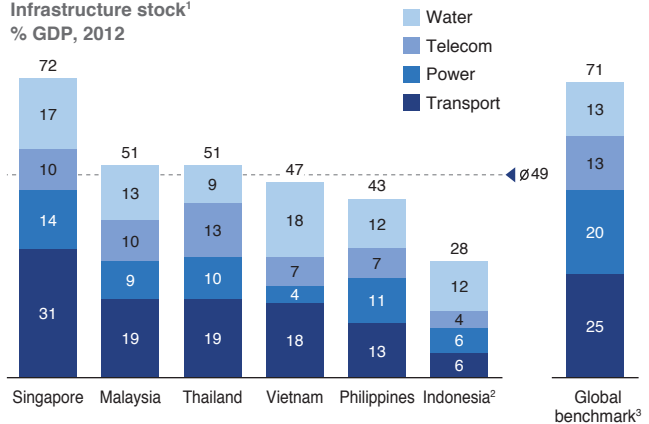
Well, talking about democracy in Indonesia: they had a

CHART 2

ASEAN infrastructure stock

Most ASEAN countries have infrastructure stock that is below the global average

Infrastructure stock¹
% GDP, 2012



Notes: 1 Estimated based on historical expenditure and using the perpetual inventory method.

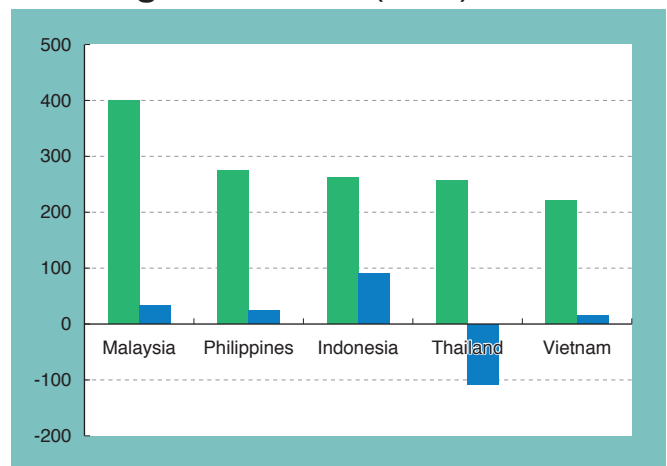
2 Transport infrastructure stock for Indonesia is understated, as expenditure for rail, ports, and airports is not available.

3 Based on a study of Canada, China, Germany, India, Italy, Poland, South Africa, Spain, UK and US.

Source: International Transport Forum; Global Water Intelligence; HIS; Perpetual Inventory method, OECD, 1998; McKinsey Global Institute analysis

CHART 3

Level of governance indicators 2014 & change from 2000 (in blue)



Source: Presentation by Prof. David Dapice, HKS conference "Understanding Indonesia" (Nov. 21, 2015)

dictatorship for 32 years. In the Philippines it was similar. You had President Ferdinand Marcos and President Suharto. Then there was the People Power Revolution in the Philippines, and then about 10 years later when Suharto resigned Indonesia went from essentially a dictatorship to a democracy. This means they went from a unitary system to a decentralized system. The good news is that a democracy is participatory and representative. The bad news is that it is really hard to get anything done. Democracy is messy because you have different interests conflicting with each other. Governance

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in democracy depends upon institutional capacity in the public sector. Their institutional capacity is under progress. It is messy. It is democracy. I think it was Winston Churchill who said democracy is the worst form of government in the world except for all the others.

Trade Policy Concerns

JS: As for trade policies, you seem to assert the need to link domestic markets to a global value chain. Trade liberalization policy might be necessary to achieve it. Our organization has been specializing in Free Trade Agreements (FTA) and Regional Trade Agreements (RTA), so do you think these kinds of efforts for regional economic integration or regional trade liberalization would be effective in achieving that policy goal?

Rosengard: Partially, but partially it is up to restructuring your domestic industries. The industries that are benefitting now are often old industries, dying industries. From the delayed restructuring process of domestic economies, it's the idea in the old system that when you make something you export it. Today it is more common to make part of something while the components might be imported. You add some value and you export it. If I look at your iPhone and ask where it was made from among all these different countries, you might have no idea of exactly which country made it. Part of this internationalization process is restructuring the organization of domestic industries. The other part of it is really up to investing in human resources so they can get higher productivity and higher value added to justify higher wages.

JS: The question concerns domestic structural reform rather than trade liberalization, but could trade liberalization also encourage domestic structural reform?

Rosengard: I think they work together. I think it's not one or the other. I think as you said, one can reinforce the other. Or you can often use a trade agreement to justify domestic reform. For example, when Vietnam joined the World Trade Organization (WTO) it could have used that as an excuse to at least partially reform state enterprises. So often the FTA or the RTA can give you the political justification. When you make these reforms that I am talking about you're challenging very strong local interests. They are powerful. And so sometimes you can say, I understand your position but I have these treaty obligations and I must do it. And I think they go together. That's why for example, in the ASEAN economic community, there are essentially now almost zero tariffs in most of the tradable goods so the problem now is non-tariff related; however, the elimination of non-tariff barriers does help to encourage more domestic opportunities in these areas that we are talking about.

Helping Nations to Achieve Economic Development

JS: How can Japan and other developed Asian nations, such as China, help Asian kittens benefit more from development? The Asian Infrastructure Investment Bank (AIIB) was founded by a Chinese initiative to develop Asian countries' social infrastructure. Is the AIIB effective in helping those countries?

Rosengard: Japan can help in a couple of ways. One is just through natural market forces from the private sector. Japan is a very large investor in Southeast Asia and it is a large trade partner. Market forces have nothing to do with any political organization. Market forces simply work through supply and demand. Market transactions are company-to-company arrangements. Secondly, Japan has also helped those countries through overseas development assistance via the Japan Bank for International Cooperation (JBIC), for example. Japan has been playing a key role in the Asian Development Bank (ADB). The AIIB is another fund in which it can help especially in collaboration with the JBIC and ADB.

The AIIB is especially good at hard infrastructure financing: basic public infrastructure like roads, electric power, and communications provides solid platforms for the private sector to invest in whether it is from abroad or domestic. I think that Japan could explore natural investment opportunities and development opportunities that facilitate growth among these nations.

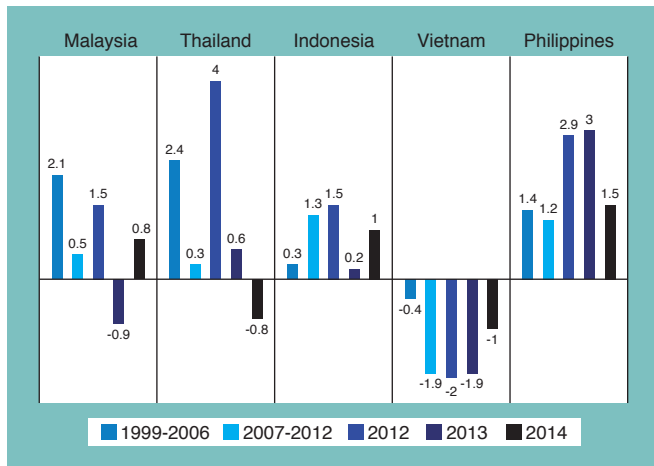
JS: Regarding the AIIB, as you know Chinese policy objectives to promote the AIIB remain unclear. It is believed that they are keen on exporting their excess capacity of infrastructure overseas.

Rosengard: It's possible. One claim that they have regarding Japanese aid is the similarity of the investment between the ADB and Japanese aid organizations. However, that is not a unique example in the world. Much European and American foreign aid is expected to benefit their own domestic industries; it is normal. You need to justify taxpayer dollars for the aid.

I think the first four investments done by the AIIB are kind of interesting. Three of them are co-financed with existing institutions, the World Bank and ADB, for projects that were previously planned. The fourth one, I think is independent. At the moment, they are basically collaborating with other international financial institutions but the long-term objective is unclear. In the short term, however, I think it gives countries another option. These are voluntary agreements and countries don't have to take the aid. I think there was reluctance to reform the governance of the existing institutions such as the World Bank and the IMF, so the AIIB and ASEAN+3 Macroeconomic Research Office (AMRO) have taken on some of

CHART 4 (a)

Total Factor Productivity growth (average annual %)



Source: Conference Board, Total Economy Database, Summary Tables May 2015

their role to better reflect the reality of the current global economy.

A country like China is not fairly represented among these institutions, which may be why it felt compelled to create a new institution. I think in some ways the shortsightedness of the current shareholders of the World Bank especially gave China a justification to establish the AIIB. And, as you said, although the long-term objectives of it might not be clear, I don't see any harm in it.

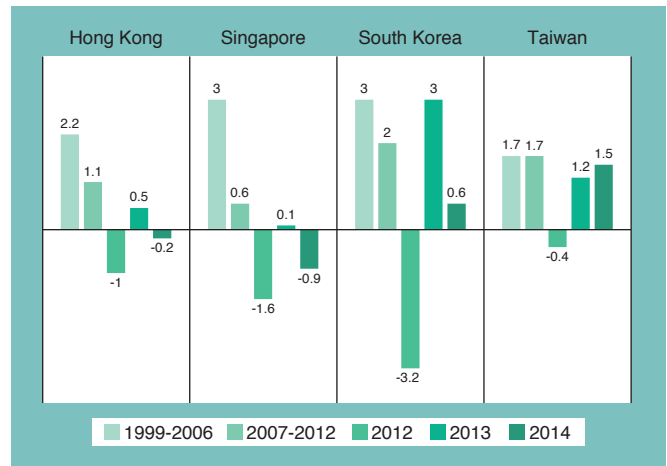
Technology Factor

JS: Regarding technology, one of the reasons we see a middle-income trap is the lack of creative technology or creative technology development efforts in some Asian countries (Chart 4). What would be necessary to raise the Total Factor Productivity growth? I would suggest more market competition-oriented policies, such as trade revitalization efforts through the Trans-Pacific Partnership (TPP) agreement or something similar. What are your thoughts?

Rosengard: I would agree that Total Factor Productivity growth has been diversified in recent years among a selection of Asian countries. I would also add that a stronger incentive has been to generate intangibles or intellectual property. A big problem in Southeast Asia is weak legal systems for protecting intellectual property rights. There is a bit of a disincentive to develop something innovative if you think you won't get fair returns because someone copies it. I think protection of intellectual property rights would help to encourage creativity.

CHART 4 (b)

Total Factor Productivity growth (%)



Notes: Total Factor Productivity growth measures the growth of GDP over the combined contributions of total hours, workforce skills, machinery and structures and IT capital. Growth rates are calculated as log differences. Growth rates for 1999-2006 and 2007-2012 are the averages of yearly growth rates. Regional aggregates are weighted using shares in nominal PPP converted GDP.

Source: Conference Board, Total Economy Database, Summary Tables May 2015

I do see in Southeast Asia, at least in the financial sector, which is encouraging, a lot of very innovative think tanks and IT start-ups. Currently in Southeast Asia, Singapore is a kind of economic center that has not really been known so much for innovation but is now becoming well known for entrepreneurship and innovation. At least it is a think tank area where a combination of what you said about opening up your markets a bit and making them more competitive is working well. The financial sector in much of Southeast Asia is pretty much a monopoly; and, having stronger intellectual property rights protection would help to activate innovation.

Income Inequality

JS: Income inequality can create a lot of impediments to economic growth as well as contribute to creating a middle-income trap. Regarding income inequality, at least in terms of an analogy with the Japanese case, social policies would seem to be more appropriate instead of market competition-oriented policies.

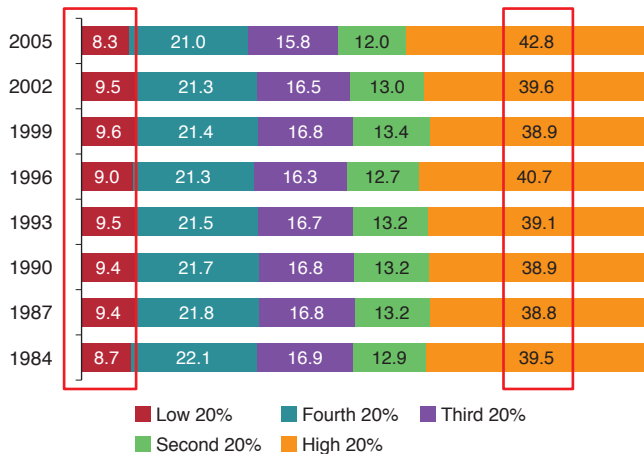
Rosengard: Chart 5 indicates inequality trends in Indonesia. I think one of the big breakthroughs, again using Indonesia as an example, is something called Conditional Cash Transfers. It is a kind of social policy but rather than simply having a welfare transfer it is really focused on getting people out of a poverty trap and intergenerational transmission of poverty; it is focused on children.

If your children attend school or a pregnant mother has regular maternity checkups and infants go to the clinic, you can receive cash. What you are basically trying to do is to enable the next

CHART 5

Measures & trends of inequality in Indonesia

Share of income by percentile of income



Source: World Bank

generation to be healthy and educated so they can obtain the skills to work their way out of poverty, which is market based. I think that is a good combination of social policy and a market-oriented policy. At a certain level you need help, you need some kind of a social transfer; however, after receiving it, you have to do your best to get out of poverty on your own. Otherwise, you will remain in poverty.

I think there is a lot of innovation going on in this area to reconcile social interventions with market forces. In Indonesia, for instance, last year they got rid of the fuel subsidy that was highly regressive. It benefitted higher income households much more than lower income households. So again, a better targeting of subsidies and better design of social transfers I think helps to deal with that tension between helping the most vulnerable and not having government interference in a market-based economy. The problem, though, is that you can have a very rapidly growing country at the same time you are having increased income inequality. You can look at GDP growing the same time inequality is growing. You can recognize that this has been a problem when you look at some of the macro statistics of those countries that you want to achieve high growth rates, but as you can see in [Chart 4](#), most of these nations have a weak Total Factor Productivity growth or even negative growth depending upon the years. However, to make them sustainable more inclusive growth would be necessary. I believe that these are some of the ways of trying to reconcile the two objectives: reducing poverty but also growing the economy.

Education & Human Resources Development

JS: We have talked about infrastructure, technology, and income inequality. The last thing we should talk

about is education policy and how to raise education levels and human resources development, as this is an important core part of structural reform.

Rosengard: First, if you look at the tigers, they have all invested very heavily in human resources. I think it is the key to being more productive and more competitive. If you look at the kittens, they have stressed access to education. In many ways there is much better access to primary and secondary education, as depicted in [Chart 6](#). They are well behind in tertiary education but the problem with access is that it is often of low quality. And so the question for those who now attend school is, are they getting a good education? And when you get to tertiary education, a lot of people are coming out of universities without skills that the market is expecting, so you have a mismatch between education and the job market. There are many people who are frustrated because they sacrificed a lot to get an education but now can't find a suitable job. I think what investment in human resources means for primary and secondary education now is that you have very good coverage, good access, so the emphasis should be on trying to improve the overall quality.

If you look at the scores of these countries on international tests they are pretty poor and that's kind of an indication of quality. When you look at tertiary education, I think there should be much greater emphasis on vocational training, which again, you can see in the tigers. As for your conventional academic training, the universities, for example, you don't see many universities in Southeast Asia with the exception of maybe in Singapore as research-based universities. Innovation is impossible without research.

As for the symbiosis between universities and related industries, there is in the United States at Harvard and MIT, for example, what they call Route 128 (Boston's Technology Corridor which is playing a crucial role in technology innovation), which is kind of our Silicon Valley. There are links between academia and research, and research and development, as well as the commercialization of products. I am less familiar with East Asia but I think we talked about hard infrastructure, which is clearly necessary for economic development as well as the significance of soft infrastructure, which is the governance or the institutional side. And third, are human resources. People are the key asset you have to develop if you want to become increasingly productive or competitive.

JS: Well perhaps Japan can be of assistance via e-learning, for example.

Rosengard: The National Graduate Institute for Policy Studies (GRIPS) in Tokyo provides e-learning courses. Many Japanese universities are introducing English-language graduate programs. So maybe not the first degree, but especially with Masters or PhDs, I see more Southeast Asians now studying in Japan in the English medium programs. You also have, as you said, distance learning,

CHART 6 (a)

Gross Enrollment Ratio (GER), secondary

Country	Average GER (%)				
	1971-1980	1981-1990	1991-2000	2001-2010	2011-2013
Singapore	n.a.	95.10 ^a	100.20	101.53	107.23
Hong Kong, China	46.82	71.48	77.84	81.34	98.49
South Korea	57.05	89.11	98.53	94.98	97.43
Taiwan	n.a.	n.a.	n.a.	99.51 ^b	99.74
Malaysia	42.26	53.63	59.01	67.65	69.02 ^c
Thailand	23.87	29.23	49.06	72.17	86.75
Indonesia	22.24	40.57	50.06	66.40	82.25
Philippines	56.05	66.36	74.91	81.66	85.27
Vietnam	39.21 ^d	34.43 ^e	57.22 ^f	n.a.	n.a.

Notes: ^a1990; ^b2008–2010; ^c2011–2012; ^d1976–1980; ^e1990; ^f1998.

Sources: Ministry of Education, Singapore as quoted in data.gov.sg; World Development Indicators (UNESCO Institute for Statistics); National Statistics, Republic of China (Taiwan)

e-learning, and my guess is you can do more in country; maybe short courses such as Life Long Learning courses. I think Japan clearly is one of the world's leaders in higher education. With the shrinking population to be seen from the most recent Japanese figures, you have now excess capacity. The universities must be hungry for foreign students and new markets. I think it might serve two purposes: it could help utilize this excess capacity in Japan and the shortage of capacity in the kittens in Southeast Asia would be mitigated.

Specific Cases

JS: You mentioned subsidies or some other specific policies that could be effective to promote structural reform in Indonesia. What would you say about Vietnam having joined the TPP? This could be the first step for it to enter on a decisive path of structural reform.

Rosengard: As for Vietnam, I think the first step for structural reform was when it joined the WTO, which has helped it very slowly reform state enterprises. The TPP will also be helpful. Again, the problem is with the politics of reform. I think one of their major reasons for joining the TPP was to deal with the domestic politics of reform. I think Vietnam is a good example if you look at the role of the state banks, as those banks dominating the economy have been in decline. However, their private banks have skyrocketed. So I think Vietnam has some very encouraging signs.

I also think the new government in the Philippines is quite committed to structural reform. The government in Indonesia, led by President Joko Widodo, has already had 12 different reform packages and again is trying to facilitate business, development, and

CHART 6 (b)

Gross Enrollment Ratio (GER), tertiary

Country	Average GER (%)				
	1971-1980	1981-1990	1991-2000	2001-2010	2011-2013
Singapore	n.a.	23.50	37.80	54.63	78.67
Hong Kong, China	8.54	17.20	28.93	44.29	62.80
South Korea	8.74	29.70	55.44	91.55	98.32
Taiwan	n.a.	n.a.	n.a.	83.04 ^a	83.89
Malaysia	3.96 ^b	5.78	15.43	30.63	36.59 ^c
Thailand	4.70	17.32	23.48	44.49	51.74
Indonesia	2.67	6.14	11.89	18.67	29.36 ^b
Philippines	18.92	25.77	27.79	28.82	32.09
Vietnam	2.19 ^d	2.29	5.03	15.35	24.54

Notes: ^a2008–2010; ^b1979–1980; ^c2011–2012; ^d1976–1980.

Sources: Ministry of Education, Singapore as quoted in data.gov.sg; World Development Indicators (UNESCO Institute for Statistics); National Statistics, Republic of China (Taiwan)

investment. Thailand, of course, has some political challenges, so things are a bit on hold. Malaysia is also going through some challenging times but among the seven middle-income ASEAN countries has the highest income and is the closest to becoming high income.

Overall, I think there are some very positive signs if you go country by country. What is implicit in your comment that I think is also very important is that when you start looking at specific policy recommendations, you should disaggregate and look at it country by country and case by case.

Concluding Remarks

JS: Overall, are you optimistic about the future of Asian economies or not so optimistic?

Rosengard: I am optimistic. I think they are generally young populations. They are generally open economies. They are very much linked to global trade and financial systems. Their leadership in general has been relatively pragmatic. I am, in general, cautiously optimistic about the kittens. Their reform is slower and a little bit difficult. But I think they are heading in the right direction. It will take longer. It will be slower and maybe a little bit more painful. But the good news is that I think a lot of the policy makers understand what has to be done and I think they are headed in the right direction. The trends are good. It is merely slow.

JS

Written with the cooperation of Damion Robert Mannings, graduate student at the University of Oxford.