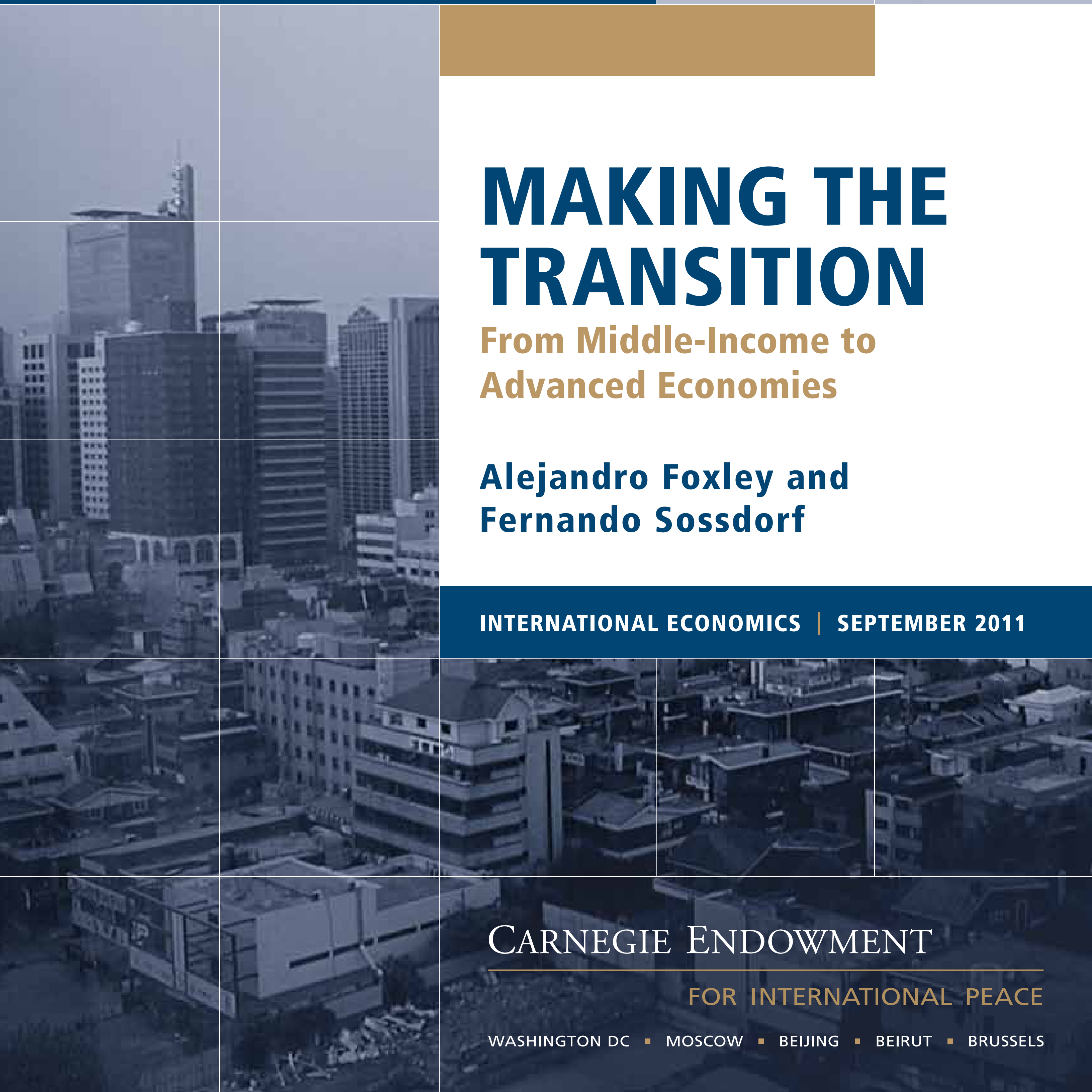
THE CARNEGIE PAPERS

MAKING THE TRANSITION

From Middle-Income to Advanced Economies

Alejandro Foxley and Fernando Sossdorf

INTERNATIONAL ECONOMICS | SEPTEMBER 2011



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Summary

Few middle-income countries have successfully transitioned into advanced economies in the past twenty years. As the world struggles with a new economic slowdown, middle-income countries should look at the lessons from the economies that successfully made the jump.

The more successful countries in the bunch—particularly Finland and South Korea—set themselves apart from the rest by investing early in improving the quality of education and inducing high investment in research and development. By opening up to world trade and using tax incentives and access to subsidized credit, successful countries were able to attract foreign direct investment in high-technology sectors. And to allow for continued growth, Finland and South Korea were able to turn financial crises into opportunities to undertake much-needed economic reforms—this was only possible because there were broad political and social agreements on the essential elements for sustaining high growth rates.

But not every newly developed economy enjoyed this level of success, notably Spain, Portugal, and Ireland. Domestic demand led to phases of high growth, but these weren't accompanied by countercyclical fiscal and monetary policies and effective regulation of the financial sector. Inevitably, high inflation, loss of competitiveness, and slow or negative growth ensued. The situations were made worse by fixed exchange rate regimes like the euro area, rigid labor markets, and a lack of competition in key markets, such as utilities and banking.

With these experiences in mind, there are four lessons that middle-income countries should learn to increase the probability that they will break through the so-called middle-income trap and successfully maintain strong economic growth rates.

Good macroeconomic management during crises is not enough.

Developing economies generally had adequate macroeconomic management during the recent global financial crisis, but this does not guarantee a successful transition toward sustained high growth. In fact, there are some early warning signs of imbalances generated by excessive capital inflows, low interest rates, and excess liquidity. These are creating consumption and construction booms in middle-income economies.

To prevent the outbreak of a new crisis, developing countries need to guarantee stable prices and growth not only through countercyclical fiscal and monetary policies, but also countercyclical management of the capital account, regulating financial sector borrowing and lending, and implementing external capital controls when required.

Rigid exchange rates and labor markets make it hard to maintain competitiveness.

Fixed exchange rates make it much more difficult to adjust to external or domestic shocks. Devaluation is not an available option and all adjustments must be made by cutting real salaries, reducing public and private spending, or raising taxes.

But flexible rates are not sufficient on their own. Unregulated capital inflows can easily turn countries into victims of their own success with excessive foreign borrowing by banks and the private sector, a significant appreciation of the currency, high inflation, and a loss of competitiveness. A more proactive role by governments and central banks may be necessary to intervene in the foreign exchange market, induce higher capital outflows in the form of sovereign saving funds abroad, and regulate or restrict capital inflows.

Less rigid and less segmented labor markets also allow for more swift economic adjustments that come with fewer negative impacts on employment. This requires reforms that change the types of work contracts and cut the cost of layoffs while increasing and improving unemployment insurance and other forms of social protection for both the formal and informal segments of the labor market.

Investments in education and innovation are essential for long-term growth.

The earlier middle-income countries increase the amount of public and private resources used to improve the quality of education, the greater the chance for a rapid transition into an advanced economy, a lesson clearly demonstrated by Finland, South Korea, and Ireland.

A similar effort to find the right institutional formula and incentives to diversify production and exports—going up the value chain through technological innovations—is clearly a challenge not yet met by most middle-income countries. This "trap" seems to be a reality for many middle-income economies.

Political and social agreements are critical to avoid stagnation.

External shocks or economic crises are impossible for any country to escape entirely, but the politics of crisis management are the key to what comes next—the two extremes being a protracted recession or a prompt resumption of high, sustainable economic growth. The capacity of political leaders to build consensus around a crisis management package and structural reforms needed for the post-crisis phase will determine the outcome.

Ireland in the late 1980s, Finland in the early 1990s, and South Korea after the Asian crisis showed that these agreements are possible and can be supported by policymakers, businesses, and labor alike. The absence of these bargains, however, explains the prevailing pessimistic outlook for the peripheral European economies.

The most productive thing middle-income countries can do to accelerate their transition to advanced economies is to establish a bipartisan political consensus for what's needed to simultaneously solve the dilemmas of an economic crisis and ensure long-term economic growth.

Introduction

Middle-income countries can be defined as those that are halfway to becoming advanced economies. The issue that motivates this work is to explore the factors that increase the probability that they will attain the condition of advanced economies within a reasonable period of time.[1]

Looking at historical precedents, we asked ourselves how many middle-income countries had managed to "graduate" to become advanced economies over the past twenty years. The graduation threshold was defined as reaching a per capita income in terms of PPP (purchasing power parity) of the last country awarded that category by the International Monetary Fund (IMF)—Portugal, with a per capita income of $23,000 in 2008.

Middle-income economies[2] were grouped into two segments. In the first one are Poland, Hungary, Estonia, and Lithuania, which are very close to passing the $23,000 threshold in the next four to five years. In the second group are the numerous countries that are not so close and will require a special effort to improve the competitiveness of their economies and thus increase their growth potential. This segment includes Malaysia and Thailand in East Asia; Bulgaria in Eastern Europe; and the vast majority of the Latin American economies.

If the IMF growth projections for these economies are accepted through 2016 and an annual per capita GDP growth rate of 5 percent is assumed, the numbers illustrated in tables 1 and 2 would be obtained.

Under these assumptions, Hungary, Poland, Estonia, and Lithuania, as indicated above, would pass the $23,000 threshold within just five years. Four Latin American countries—Argentina, Chile, Mexico, and Uruguay—would do so within a decade. Latvia, Bulgaria, and Romania would take around ten years. In East Asia, Malaysia is in the best position to reach that goal in ten years. In contrast, Thailand would have to make a sustained effort to attain advanced economy status in twenty years.

This group of middle-income economies will be the focus here. Their transition to developed country status is not guaranteed, however. As the economic literature illustrates, some of them have already shown themselves to be prone to falling into what has been called the middle-income trap. An example is a recent study of East Asia in 2007 (*An East Asian Renaissance*, World Bank). Authors Homi Kharas and Indermit Gill refer to the concept of the middle-income trap as a drop in historic growth rates that would slow down middle-income economies' leap to high-income country status. Ivailo Izvorski (2011) picks up on the concept and finds that close to two-thirds of low- to middle-income countries in 1960 were still languishing in that category as late as 2009.

Table 1. Per Capita GDP Growth Rates

	2009	2010	2011(e)	2012(p)	2013(p)	2014(p)	2015(p)	2016(p)	2016–2031(p)
Argentina	-0.1	8.1	5.0	3.6	3.3	3.1	3.1	3.1	5.0
Brazil	-1.6	6.5	3.6	3.3	3.3	3.4	4.2	4.2	5.0
Chile	-3.0	4.0	4.6	3.7	3.2	3.5	3.4	3.4	5.0
Colombia	0.3	3.1	3.4	3.3	3.2	3.3	3.3	3.3	5.0
Mexico	-6.9	4.5	3.6	3.0	2.3	2.2	2.2	2.2	5.0
Peru	-0.7	7.1	5.9	4.2	4.1	4.1	4.1	4.1	5.0
Uruguay	2.2	8.1	4.6	3.8	3.7	3.7	3.7	3.6	5.0
Bulgaria	-4.9	0.6	3.5	4.0	4.5	4.5	4.5	4.5	5.0
Estonia	-13.7	3.7	3.5	3.8	3.8	3.8	3.8	3.6	5.0
Hungary	-6.6	1.4	2.9	3.0	3.0	3.2	3.4	3.4	5.0
Latvia	-17.6	0.2	3.6	4.4	4.3	4.3	4.3	4.4	5.0
Lithuania	-14.3	2.8	5.2	4.4	4.3	4.3	4.1	4.1	5.0
Poland	1.7	3.9	3.9	3.6	3.7	3.7	3.9	3.9	5.0
Romania	-6.9	-1.1	1.7	4.6	4.5	4.5	4.4	4.3	5.0
Malaysia	-3.0	5.8	3.7	3.4	3.3	3.3	3.2	3.2	5.0
Thailand	-2.5	7.2	3.3	3.9	4.1	4.1	4.2	4.4	5.0

Source: World Economic Outlook Database, IMF, April 2011
e: estimate; p: projected

Table 2. GDP Per Capita (PPP, constant 2008 dollars), Base Scenario

	GDP per capita PPP	Year
Argentina	23,285	2020
Brazil	23,390	2027
Chile	23,267	2021
Colombia	23,687	2031
Mexico	23,227	2023
Peru	23,496	2030
Uruguay	23,581	2022
Malaysia	23,572	2022
Thailand	23,730	2031
Bulgaria	22,811	2023
Estonia	23,765	2017
Hungary	23,240	2017
Latvia	23,220	2021
Lithuania	22,931	2017
Poland	23,212	2016
Romania	22,809	2025

Source: Authors’ calculations based on World Economic Outlook, IMF, April 2011

Only a handful of countries were able to make the transition to advanced economies over the last fifty years. These include most countries in Western Europe and Japan, South Korea, Singapore, Taiwan, Slovakia, Slovenia, and the Czech Republic.

The decline in growth rates can be explained, among other factors, by the failure to diversify production away from low-tech, labor-intensive products. Thus, when an economy starts with very low initial income per capita ($100 to $5,000 per year), it exploits its main comparative advantage, which is the abundance of labor. This allows a pattern of specialization based on labor-intensive products. As the abundance of labor is gradually exhausted, a middle-income country then should move toward products that make more intensive use of physical and human capital.[3] This poses a requirement of significant investment in human capital and innovation.

Only a handful of countries were able to make the transition to advanced economies over the last fifty years.

Given this conceptual framework, there has been an increase in the number of studies over recent years regarding the countries that might fall into the middle-income trap. Malaysia, Thailand, and a large number of Latin American countries often have been labeled as likely candidates.[4]

This study offers a comparative perspective that focuses on developed countries that had varying levels of success in the transition from middle-income economies to advanced economies in the last twenty years. Some of the candidates can be seen in table 3.

The cases of Finland, South Korea, Ireland, Spain, and Portugal[5] were selected because of the varied nature of the development paths they chose to speed up their transition to becoming advanced economies. Finland and South Korea can be catalogued as economies with overall successful trajectories. They did not escape domestic financial crises in the 1990s but were able to turn the crises into opportunities for implementing reforms for sustainable economic development.

For its part, Ireland went through a strong boom period from 1987 to 2000 that allowed it to go from being Europe's poorest country to an advanced developed economy, only to subsequently fall victim to its own prosperity. In

Table 3. Transitions From Middle-Income to Advanced Income

Country	Growth phase in transition	Income PPP per capita at the start and end of the phase in transition		Total time in years
Finland	1972–1988	15,074	23,757	16
South Korea	1994–2004	15,908	23,854	10
Ireland	1987–1995	15,402	22,928	8
Spain	1973–1996	15,368	23,375	23
Portugal	1988–2007	15,374	23,120	19

Source: Authors' own work based on World Economic Outlook, IMF, April 2011 fact, in the past decade, its high growth rate was based mainly on an uncontrolled financial boom.

Spain also provides a good case study. After Spain restored its democracy, it experienced remarkable economic growth spurred by the depth of the structural reforms implemented by the government of Felipe González. The fruits of these reforms were reaped from 1993 onward, when the Spanish economy managed to achieve thirteen years of strong and sustained growth before becoming mired in the difficult crisis that continues to afflict the Spanish economy today and whose outcome remains uncertain.

Lastly, Portugal has been embarked on a course of unstable growth, with severe structural obstacles that have prevented it from attaining sustainable growth.

None of these economies has escaped financial crises or shocks since making the transition from being a middle-income country to an advanced economy. Some of the crises or shocks originated in external factors, such as the collapse of the Soviet Union and its impact on Finnish exports. But more often the crises were self-inflicted, such as excessive expansion of spending and indebtedness, leading to economic adjustments that held up growth. This was the case of Ireland in the late 1980s, Finland in 1992, and South Korea after the Asian crisis of 1997–1998. Spain and Portugal are experiencing their worst financial shock of the last few decades, causing a weakening of their governments and leaving them incapable of reaching a political and social consensus to get out of the crisis.

Five Case Studies: Countries That Succeeded in Transitioning From Middle-Income to Advanced Economies

For a better understanding of the fundamental events or factors that sparked the accelerated growth phase in these economies, or the ones that slowed down that process, it is worth reviewing the trajectory of the economic policies that were implemented in the last three decades.

Finland's economic development continuity[6]

The Finnish economy experienced significant and fairly stable economic growth throughout the entire postwar period up to the early 1990s. This stability of the economy is characterized by two periods (see table 4).

The first period was from 1945 to 1970. During this period, the state took an active role in promoting economic development. It used instruments such as controlling interest rates and giving a prominent role to a state bank—the Bank of Finland[7]—which awarded major loans to companies, private or public, so that they would undertake large investment projects. An important part of the policy prerogatives of the Bank of Finland included most decisions pertaining

Table 4. Economic Indicators of Finland

Period	Economic Indicators						
		Macroeconomic Indicators (annual average of the period or year specified)					Trade Indicators
	GDP Per Capita PPP (2008 dollars)	GDP Growth (%)	Fiscal Balance (% GDP)	Public Debt (% GDP)	Current Account (% GDP)	Inflation (%)	Exports (% GDP)
1945–1970	1960: 9,236 1970: 14,200	5.2%	1960: 4.5% 1970: 4.9%	1960: 16.9% 1970: 15.9%	1960: -0.9% 1970: -2.4%	1961–1970: 5.9%	1960: 21.1% 1970: 24.2%
1970–1990	1970: 14,200 1990: 25,363	3.5%	4.1%	12.0%	-2.3%	9.1%	26.3%
1991–1993	1991: 23,646 1993: 22,322	-3.4%	-6.1%	32.9%	-3.8%	1.3%	26.5%
1994–2008	1994: 23,015 2008: 36,194	3.4%	1.9%	60.0%	5.1%	1.7%	40.1%
2009	2009: 33,131	-8.0%	-3.0%	75.2%	1.3%	0.9%	37.4%
2010	2010: 33,771	2.4%	4.7%	88.7%	1.4%	1.3%	40.1%

Source: Author calculations based on IMF, World Bank, and database of IADB and Ministry of Foreign Affairs (2009)

to foreign exchange control and guidelines and recommendations that the state bank issued to commercial banks. Thus, a characteristic of the period was low interest rates and administrative rationing of credit to some areas of business investment, at the expense of depositors and households.

Likewise, two ambitious reforms were introduced at this stage. One was intended to improve the coverage and quality of the education system (1968), and the other was a new approach to stimulate expenditure in science and technology (1967).[8]

Over this period, the main vulnerabilities of the Finnish economy had to do with major fluctuations in the price of forestry products, the country's main export product. This period is also characterized by an incipient industrialization and a nascent social protection system.

The second period spans 1970–1990. During this period, Finland dealt with an oil shock. As a response to the crisis, countercyclical macroeconomic policies were implemented that kept Finnish fiscal accounts balanced. At the same time, the country was able to ensure a supply of oil at preferential prices from its main trading partner, the Soviet Union, and a process of financial liberalization was gradually undertaken.

The financial liberalization implemented from 1985 to 1992 led eventually to an excessive credit expansion. That induced a boom in the price of assets, which in turn overheated the economy. In addition, the fall of the Soviet Union caused Finnish exports to collapse. These two factors together generated a deep recession in 1992–1993.

The recession precipitated significant social and economic damage, with unemployment rising from 3.2 percent in 1990 to 16.4 percent in 1993. Excessive levels of corporate and personal debt led to a crisis in the banking sector, requiring a financial rescue package by the government that caused public debt to rise from 14 percent of GDP in 1990 to 55 percent in 1993.

The exceptional thing about the way that the crisis in the 1990s was handled in Finland is that the government managed to forge a broad-based political and social consensus that allowed significant macroeconomic adjustments to be made, along with reorienting the country's production and exports toward high-technology sectors. This move was made possible by a significant investment in quality education and by a creative innovation policy that Finland had implemented as a shared national goal since the 1970s. This process was later accompanied by fiscal consolidation, including pension reform and strengthened financial regulation in order to minimize the risk of a future banking crisis.

The exceptional thing about the way that the crisis in the 1990s was handled in Finland is that the government managed to forge a broad-based political and social consensus that allowed significant macroeconomic adjustments to be made, along with reorienting the country's production and exports toward high-technology sectors.

Thus, when the current financial crisis erupted, Finland was in a relatively healthy position in terms of its macroeconomic indicators. It ran a fiscal surplus of 3.2 percent of GDP as an average in the period before the crisis spanning 2004–2008, while during the same years public debt went down from 44 percent of GDP to 35 percent. Meanwhile, annual GDP growth reached an average of 3.5 percent, and unemployment fell from 8.8 percent in 2004 to 6.4 percent in 2008. Having learned from past mistakes, the financial sector did not have toxic assets and was well capitalized.

In fact, during the current global financial crisis, the government has not been required to rescue a single bank. And after a negative GDP growth of 8 percent in 2009, the economic situation in Finland improved. GDP growth was 2.4 percent in 2010, with a positive outlook for the following years.

South Korea's successful model[9]

Among East Asian countries, South Korea represents an exceptional case of a swift transition to an advanced economy. The South Korean economy went from a per capita income level around $2,000 in 1960 to a GDP per capita of $28,000 in PPP by 2008, solidly placing it in the group of developed countries (see table 5).

South Korea's quick transition is typically divided into three stages. The first began in 1962, with the introduction of five-year plans intended as guidelines to better coordinate public-private efforts to improve the performance of the economy. This resulted in accelerated development through 1997, with an annual growth rate of 7 percent.

The first phase was characterized by high levels of savings and investment and by a determined industrial policy that implied a continuous technological "upgrade" to align exports with South Korea's evolving comparative advantages in successive phases of its development.[10] On the labor market, the South Korean authoritarian government at the time outlawed unions and created conditions for a repressed labor market with cheap and abundant labor.

The second stage covered the 1997–1998 financial crisis, which slowed the economy and increased unemployment. In spite of rather solid economic fundamentals such as balanced fiscal and current accounts, a low public debt of just 8 percent of GDP in 1996, and high domestic saving and investment (34 percent of GDP and 38 percent of GDP in 1996, respectively), imbalances had accumulated in the domestic private financial markets. Some of the symptoms were a high ratio of short-term private external debt to international reserves (207 percent in the second quarter of 1997); overinvestment in manufacturing sectors that had displayed an excess capacity even before the crisis took hold (the ratio of debt to assets of the 30 largest companies in Korea was 519

Table 5. Economic Indicators of South Korea

Period	Economic Indicators						
		Macroeconomic Indicators (annual average of the period or year specified)					Trade Indicators
	GDP Per Capita PPP (2008 dollars)	GDP Growth (%)	Fiscal Balance (% GDP)	Public Debt (% GDP)	Current Account (% GDP)	Inflation (%)	Exports (% GDP)
1962–1997	1962: 1,704 1997: 18,239	8.0%	1975–1997: -1.0%	1980–1997: 13.4%	1975–1997: -1.4%	14.10%	24.40%
1998	1998: 16,867	-6.9%	0.9%	14.30%	11.30%	5.80%	44.30%
1999–2008	1999: 18,336 2008: 26,875	5.3%	2.3%	22.90%	1.80%	2.40%	39.50% 1999: 37.2% 2008: 53.0%
2009	2009: 26,850	0.2%	0.0%	32.60%	5.20%	3.40%	49.90%
2010	2010: 28,389	6.1%	1.4%	32.10%	2.60%	2.20%	54.80%

Source: Author calculations based on IMF, World Bank, and database of IADB and Ministry of Foreign Affairs (2009) percent in 1997); and a nonregulated process of financial liberalization that induced overindebtedness on the part of the private sector (nonperforming loans increased from 3.9 percent of total credits in December 1996 to 6.1 percent in June 1997).

The South Korean financial crisis involved a solvency crisis for many banks and businesses and morphed into a generalized economic crisis. The outcome was negative growth in 1998, with a sharp increase in unemployment (from 2.4 percent in 1997 to 6.8 percent in 1998) and a higher rate of poverty (from 11.4 percent in 1997 to 23.2 percent in 1998).

The reasons for South Korea's swift recovery are centered on aggressively countercyclical monetary and fiscal policies; significant growth in the export sector; and high inflows of foreign direct investment.

The third phase in the development of the South Korean economy was characterized by rapid recovery from the crisis. GDP growth in 1999 was 10.7 percent (the highest it had been since 1988 and the highest in East Asia). Exports went up by close to 9 percent in 1999 and 18.2 percent in 2000. Unemployment dropped from 6.8 percent in 1998 to 4.5 percent by the end of 1999. The share of poor households fell from 23.2 percent in 1998 to 18.0 percent in 1999. Subsequently, the South Korean economy was able to sustain an annual growth rate of 5 percent from 1998 to 2008.

The reasons for South Korea's swift recovery are centered on aggressively countercyclical monetary and fiscal policies; significant growth in the export sector; and high inflows of foreign direct investment. In addition, the country implemented economic reforms that included measures to restructure the business sector, banking, the public sector, and the labor market.[11]

However, after a decade of rapid growth, the South Korean economy was not immune to the current global recession. In November 2008, exports were down 19.5 percent annually, and they continued to drop until mid-2009. The economy grew by just 2.3 percent in 2008. But it recovered in 2010 to a growth rate of 6.2 percent, similar to the one achieved before the crisis.[12]

This swift recovery in the South Korean economy has been led by rapid growth in exports due to the depreciation of the South Korean won; strong demand in China; and an effective and aggressive monetary and fiscal policy response.

Ireland's miracle and collapse[13]

The evolution of GDP per capita in Ireland between 1970 and 2007 bears witness to the "Irish miracle." In effect, GDP per capita was $10,297 in 1970 and rose to $45,735 in 2007 (see table 6).

Prior to a boom that started in 1987, Ireland had gone through a period of moderate expansion between 1960 and 1973. In this period, the annual growth rate was 4.4 percent. Part of this result was made possible by trade and industrial policy reforms that were implemented to refocus the Irish economy toward "outward-oriented" economic development. Important accompanying measures to trade liberalization were a set of incentives, the main one being low corporate tax rates, to attract foreign investment. In addition, a profound educational reform had been under way since 1965.[14] Some economic constraints in this period were the high levels of emigration; unemployment above European Union (EU) averages; and salary increases often exceeding productivity levels. These constraints led to a period, between 1973 and 1986, during which growth was sluggish (it averaged 3.6 percent per year for the period and was even negative in the early 1980s) in a context of high oil prices and high inflation (12.6 percent per year).

As a consequence, a stabilization plan had to be implemented in 1987 under a new government. The plan involved fiscal consolidation, a tripartite agreement on moderation of salary increases, and tax reform that lowered personal taxes. This was the basis of the so-called Social Partnership Agreement. Likewise, funds from the EU allowed public investment to be sustained in spite of the drop in government expenditures, as a result of the fiscal consolidation plan agreed upon as part of the tripartite agreement.

Table 6. Economic Indicators of Ireland

Period	Economic Indicators						
		Macroeconomic Indicators (annual average of the period or year specified)					Trade Indicators
	GDP Per Capita PPP (2008 dollars)	GDP Growth (%)	Fiscal Balance (% GDP)	Public Debt (% GDP)	Current Account (% GDP)	Inflation (%)	Exports (% GDP)
1960–1973	1960: 6,971 1973: 10,855	4.40%	-3.50%	41.40%	-2.50%	7.20%	33.00%
1973–1987	1973: 10,855 1987: 15,300	3.60%	-9.80%	73.90%	-7.90%	12.60%	45.90%
1987–2000	1987: 15,300 2000: 34,157	6.80%	-1.40%	81.30%	1.10%	3.40%	70.90%
2000–2007	2000: 34,157 2007: 43,825	6.00%	1.50%	30.40%	-1.90%	3.50%	87.80%
2008–2009	2008: 41,850 2009: 38,355	-5.60%	-11.00%	55.00%	-4.10%	-4.00%	94.50%
2010	2010: 38,136	-0.30%	-34.00%	93.70%	-2.70%	-1.90%	101.90%

Source: Author calculations based on IMF, World Bank, and database of IADB and Ministry of Foreign Affairs (2009)

Throughout the 1990s, strong growth was led by the export sector and a dynamic services sector (especially financial services, which were boosted by the installation of an international financial services center in 1987). The production boom caused the unemployment rate to drop from 16 percent in 1986 to 4 percent in 2000.

Ireland's 1987–2000 phase of high growth incubated vulnerabilities.

Ireland's 1987–2000 phase of high growth incubated vulnerabilities. One was overexpansion of the construction sector, particularly during a real estate boom in the decade after 2000. The construction expansion was financed by the Irish banking system, which obtained funds from international financial markets and, in the process, accumulated high levels of external liabilities. In addition, an imbalance in Irish public finances was generated during this stage. When the economy collapsed in 2008, a severe structural budget deficit totaling 7 percent was detected.

What followed is well known: a financial crisis that prompted Irish authorities to rescue banks and purchase toxic assets. As a consequence of the government's taking on the high levels of bank debt, the nation's deficit reached 32 percent of GDP in 2010 and public debt stood at over 90 percent of GDP.

Spain's good and bad booms[15]

The modernization of the Spanish economy has developed swiftly over the past three decades. This period coincides almost precisely with Spain's transition to democracy and its subsequent accession to the European Union in 1986. Both were fundamental factors sustaining positive growth from 1994 to 2008, with growth rates (3.5 percent per year in this period) that surpassed the average of Spain's European counterparts (see table 7).

The arrival of the Felipe González administration in 1982 signaled the start of structural changes that prompted a ten-year period of rapid expansion. The main characteristics of these reforms were countercyclical economic policy with major tax reform aimed at increasing government revenue and controlling tax evasion; restructuring and reconversion of industry under the 1984 law; labor reform in 1984 to combat rigidity in a market characterized by high levels of unemployment and high layoff costs; active promotion of foreign direct investment; and admission into the European Union, which added dynamism to foreign trade.

The subsequent phase, from 1994 to 2008, can be separated into two periods. Until 1999 and coinciding with the introduction of the euro as a single currency, the engine of growth was dynamic domestic demand. Private consumption expanded rapidly over this period, owing to strong job creation and loose monetary conditions, which induced positive expectations of higher income on the part of households. Job creation was such that the unemployment rate, which exceeded 18 percent in the mid-1990s, declined to 11 percent in 2003.

Table 7. Economic Indicators of Spain

Period	Economic Indicators						
		Macroeconomic Indicators (annual average of the period or year specified)					Trade Indicators
	GDP Per Capita PPP (2008 dollars)	GDP Growth (%)	Fiscal Balance (% GDP)	Public Debt (% GDP)	Current Account (% GDP)	Inflation (%)	Exports (% GDP)
1950–1975	1950: 5,144 1975: 16,375	5.7%	1965–1975: 0.3%	1960–1975: 12.3%	1960–1975: -0.5%	1960–1975: 8.4%	1960–1975: 10.5%
1975–1981	1975: 16,375 1981: 16,961	1.5%	-1.1%	14.4%	-1.9%	17.1%	14.1%
1982–1992	1982: 17,081 1992: 22,675	3.0%	-4.6%	39.2%	-1.3%	8.7%	18.2%
1993	1993: 22,371	-1.0%	-6.8%	57.2%	-1.1%	4.5%	18.2%
1994–2008	1994: 22,843 2008: 31,674	3.5%	-1.8%	53.6%	-4.1%	3.6%	25.9%
2009	2009: 30,054	-3.7%	-11.2%	53.1%	-5.5%	0.6%	23.4%
2010	2010: 29,825	-0.4%	-9.2%	63.5%	-5.2%	0.0%	26.0%

Source: Author calculations based on IMF, World Bank, and database of IADB and Ministry of Foreign Affairs (2009)

In parallel, the construction sector seemed to be enjoying a golden age, particularly as a result of the strong demand for housing investment. Its rate of expansion was unsustainable, however, and led to a residential investment bubble from 1999 on.

Spanish productivity, meanwhile, has remained relatively stagnant since 1999 compared with the country's European counterparts. Salary increases have been consistently higher than productivity, causing an increase in labor costs. That in turn has hindered Spain's competitiveness.

Portugal's unstable course of growth[16]

Portugal has traveled a highly unstable path to development over the past four decades. Brief episodes of high growth have been followed by periods of stagnation caused mainly by a lack of needed structural reforms (in education, innovation, industrial policy, and competition in the goods and services market). Despite this, there are two instances of significant economic growth. One

Table 8. Economic Indicators of Portugal

Period	Economic Indicators						
		Macroeconomic Indicators (annual average of the period or year specified)					Trade Indicators
	GDP Per Capita PPP (2008 dollars)	GDP Growth (%)	Fiscal Balance (% GDP)	Public Debt (% GDP)	Current Account (% GDP)	Inflation (%)	Exports (% GDP)
1950–1974	1950: 3,207 1974: 11,656	5.5%	1965–1974: 0.9%	1960–1974: 1.9%	1960–1974: -2.7%	1960–1974: 5.0%	1960–1974: 19.6%
1975–1985	1975: 10,735 1985: 13,067	2.3%	-4.4%	36.7%	-4.8%	21.0%	20.9%
1986–1991	1986: 13,609 1991: 18,107	5.5%	-5.0%	58.2%	0.2%	12.6%	28.1%
1992–1995	1992: 18,253 1995: 18,705	1.1%	-4.6%	56.6%	-0.6%	7.4%	25.4%
1996–2001	1996: 19,328 2001: 22,708	3.8%	-1.8%	52.1%	-7.6%	3.4%	27.9%
2002–2008	2002: 22,714 2008: 23,254	0.8%	-1.4%	60.3%	-9.6%	2.8%	29.6%
2009	2009: 22,633	-2.6%	-9.3%	76.3%	-10.0%	0.2%	27.9%
2010	2010: 22,866	1.1%	-7.3%	83.1%	-10.0%	0.7%	30.9%

Source: author calculations based on IMF, World Bank, and database of IADB and Ministry of Foreign Affairs (2009)

coincided with Portugal's entry into the EU in January 1986 and lasted until 1991. The other went from 1995 to 2001, which overlapped with the adoption of the euro in 1999 (see table 8).

Portugal began a modernization phase during the Salazar dictatorship. With the arrival of democracy in 1974 came a gradual process of "creative destruction" that pushed Portugal's productive structure toward labor-intensive industries with low levels of growth in productivity.

Macroeconomic imbalances and political mismanagement from 1975 to 1985 led to a decade of political instability, growing unemployment, external imbalances (a current account deficit of 4.8 percent in this period), and deteriorated public finances (an average budget deficit of 4.4 percent).

A phase of favorable internal and external conditions prevailed from 1986 to 1991. A new economic stabilization program was implemented from 1983 to 1985. Oil prices fell sharply in 1986, and privatizations were started. At the same time, the Portuguese economy benefited from massive transfers of structural funds from the European Union. In addition, for the first time since the transition to democracy, a government with an absolute majority in Parliament was elected (in 1987, and again in 1991). On the external front, accession to the European Union in 1986 opened up new markets for the labor-intensive products that were Portugal's comparative advantage. The average annual growth rate in the 1986–1991 period was 5.6 percent.

After a recession in 1992–1994, GDP growth picked up again in 1995 and was sustained until 2000. The key factor in this cycle was an expanding domestic demand—and particularly rising household debt induced by low real interest rates—and a pro-cyclical public sector. This resulted in higher public debt and rising fiscal deficits, increases in unemployment, and massive levels of household indebtedness (household debt as a share of disposable income was 120 percent in 2004, compared with 80 percent in the eurozone).

From 2002 to 2008, Portugal's growth rates slowed to 0.8 percent per year. A significant factor, beyond macro imbalances, was that reforms to improve the quality of education and innovation were not done in a timely manner. Nor had the country gained access to new markets. All of these factors are requisite for competitiveness and higher growth rates.

From 2002 to 2008, Portugal's growth rates slowed to 0.8 percent per year. A significant factor, beyond macro imbalances, was that reforms to improve the quality of education and innovation were not done in a timely manner.

Useful Lessons Based on the Experiences Described

The paths to economic development that these five countries have taken illustrate some of the key factors that explain the longest-lasting phases of growth. At the same time, some recurrent mistakes in economic policy have caused several of these economies to return to periods of instability characterized by rising inflation, excessive spending increases (including salaries), and loss of international competitiveness.

Some lessons can be drawn from the successes and failures in policy design and implementation by these advanced economies.

Sound fiscal policy not complemented by countercyclical monetary policy and financial regulation may lead to a boom-bust cycle.

The recent cases of Ireland and Spain, among others, indicate that even sound macroeconomic policies that are not accompanied by adequate supervision and regulation of the financial sector can inflict serious damage on the economy.

Ireland and Spain faced a sharp drop in nominal and real interest rates on the way toward adopting the euro. This induced significant growth in lending by the domestic banks, accompanied by high levels of household and corporate debt.

The recent cases of Ireland and Spain indicate that even sound macroeconomic policies that are not accompanied by adequate supervision and regulation of the financial sector can inflict serious damage on the economy.

As an example of the magnitude of accumulating imbalances, Ireland's supply of credit reached 200 percent of GDP by 2008, compared with an annual average of only 40 percent from 1970 to 1994. Residential investment accounted for 5 percent of GDP in the mid-1990s; in 2007, it had escalated to 12 percent of GDP.

In Spain, the adoption of the euro was followed by a combination of inflation above the EU average and almost no growth in productivity after 2000, while increases in real salaries were outpacing those of counterparts in the eurozone. Thus, unit labor costs grew by 30 percent since 2000. A residential investment bubble brought with it high levels of household debt and a troubled banking system.

As in the case of Ireland, Spanish monetary and regulatory policies proved incapable of containing the financial bubble. Macroeconomic indicators were not particularly out of balance up to 2007, as shown in tables 6 and 7. Budget equilibrium and low public debt in both Ireland and Spain characterized the decade that preceded the current crisis. However, inadequate financial regulation and low interest rates led to excessive credit expansion, which made the boom-bust cycle unavoidable.

Labor market and exchange rate rigidities act as a constraint to maintain competitiveness.

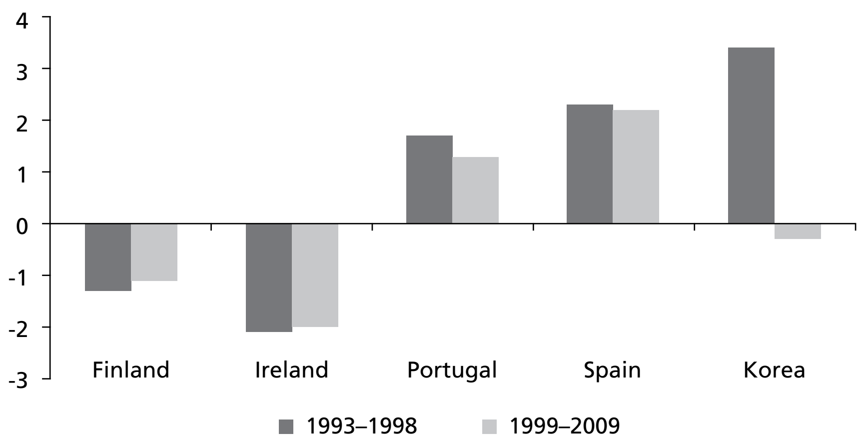
Two factors made for a deeper financial crisis in Spain and Portugal: rigid and segmented labor markets, and a fixed exchange rate after entering the eurozone.

The Spanish case illustrates the imperfections and rigidities in the labor market. About two-thirds of the labor force have permanent contracts, are highly unionized, and benefit from a centralized wage-bargaining mechanism. A full third of workers are under temporary contracts and are not unionized. Hiring and firing costs for that segment of the labor force are much lower than for the first segment. This dual, highly segmented labor market still prevails in Spain in spite of numerous attempts since the early 1980s to make it more flexible and less fragmented.

The outcome given this structure is a decoupling of wage increases in the unionized sector from the business cycle and from increases in productivity. When wage increases are out of line for this segment as a consequence of union power in centralized or sectorial negotiations, adjustment comes via higher inflation and by laying off workers with temporary contracts. The result is inflation targets that are not met, a sharp rise in unemployment, and a loss of competitiveness for the economy as a whole.

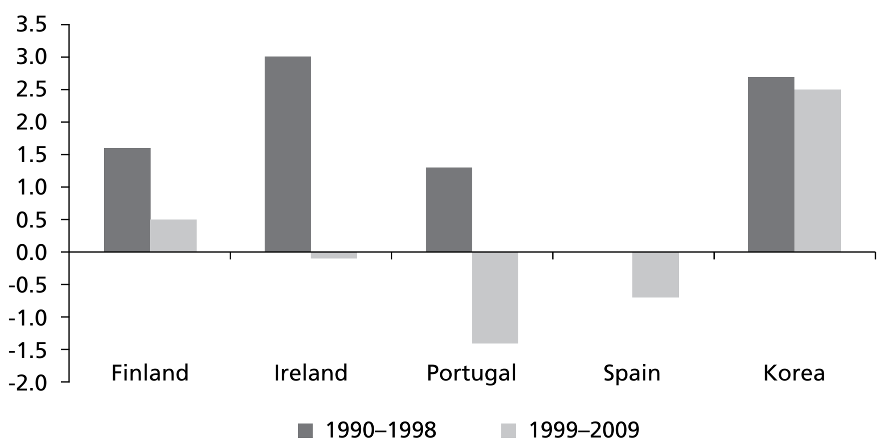
In Spain, unit labor costs rose 2.2 percent in 1999 to 2008, while productivity showed a negative growth rate of 0.6 percent per year, well below the rising labor costs. This type of outcome is also observed in the Portuguese economy, where unit labor costs rose 1.3 percent per year in the same period and productivity had a negative growth rate of 1.3 percent per year. (See figure 1 for unit costs and figure 2 for productivity.)

Figure 1. Unit Labor Cost Growth (%)



Source: OECD

Figure 2. Total Factor Productivity Growth (%)



Source: The Conference Board Total Economy Database, January 2011

With regard to the exchange rate, one of the major problems that the countries had to deal with during the recent financial crisis was a fixed rate. Adoption of the euro meant renouncing the exchange rate as an instrument to adjust the economy when confronting adverse economic shocks. Given lax monetary policy on the part of the European Central Bank and lack of coordination of European fiscal policies, the scenario for increased imbalances had been set. Real salary increases that were out of line with the level of productivity translated into higher inflation and appreciated real exchange rates. This appreciation clearly affected the export sectors of Ireland, Spain, and Portugal and, given their membership in the eurozone, could not be accompanied by nominal devaluations.

Human capital and innovation policies are key to sustained long-term growth.

Finland, Ireland, and South Korea adopted active human capital and innovation policies early on. Those steps were to become the foundations of their transition to knowledge-based economies.

Reform of the countries' education systems began in the 1950s and 1960s at the primary levels, soon followed by changes in secondary and higher education. The gradual nature of the reforms was a key factor in their improvement. The tertiary sector was additionally induced to engage in a permanent dialogue with the business sector, so as to align curricula with companies' requirements for higher skills in the labor force.

Finland, Ireland, and South Korea adopted active human capital and innovation policies early on. Those steps were to become the foundations of their transition to knowledge-based economies.

In Ireland, education reform was accompanied by the creation in 1967 of technical colleges whose objective was to train a workforce with applied skills.

Finland reformed the primary and secondary levels in the 1970s by implementing nine years of mandatory primary education, and in the late 1980s secondary education was divided into a vocational/technical track and an academic secondary school. In tertiary education, the polytechnics were created in the early 1990s to develop human capital specific to regional and business needs.

South Korea's first plan of mandatory education was begun in 1954, and it was focused on the first six years of elementary school education. In the 1970s, reforms of vocational and technical secondary education, especially in science and technology, were carried out, having in mind the strong growth in such sectors as chemical and heavy industries.

In innovation policy, meanwhile, these three countries made a distinct choice. Finland developed an endogenous innovation model, that is, a gradual policy that would design new state institutions or reform existing ones to support the technological development and upgrade of domestic companies, which were fundamental to improving Finnish competitiveness.

For its part, since the 1970s Ireland applied a model of bringing in foreign technology through an active policy to attract foreign direct investment. It did so with such incentives as low corporate tax rates, ample availability of subsidies to facilitate operation, and rapidly expanding qualified labor.

In South Korea, industrial policy has been at the core of the economy's technological development, with the export sector being the main focus of the "technology upgrade." For an extended period of time, South Korean industry was highly protected but under market discipline. That is, the industries that were protected and subsidized were required to prove that their competitiveness in international export markets was gradually improving.

Expenditures in research and development by these three countries as a percentage of GDP are shown in table 9. Finland and South Korea are spending more than 3 percent of GDP in R&D. That explains at least in part the high relative places achieved when comparing the importance of innovation in a ranking of a large sample of countries as seen in table 9.

Table 9. Research and Development Expenditure, Private and Public (% of GDP), and Global Ranking in Innovation

	2007	Ranking in Innovation
Finland	3.5	3
Ireland	1.3	22
Portugal	1.2	32
Spain	1.3	46
South Korea	3.2	12
Malaysia	0.6 (2006)	24
Thailand	0.2 (2006)	52
Argentina	0.5	73
Brazil	1.1	42
Chile	0.7 (2004)	43
Colombia	0.2	65
Mexico	0.4	78
Peru	0.1 (2004)	110
Uruguay	0.4	58

Source: World Development Indicator 2009, World Bank. Ranking in Innovation from Global Competitiveness Report 2010–2011.

Social and political consensus provide the most solid foundation for relaunching rapid growth in the economy.

In their transition to developed economies, Finland, Ireland, and South Korea faced varying and often complex scenarios characterized by periods of political instability, social protests, and macroeconomic imbalances. However, when some of these critical situations were followed by the emergence of social and political consensus in order to stabilize the economy and restore its competitiveness, a long phase of high and stable growth followed.

As an example and as mentioned previously, Finland's economy went through a deep crisis in the early 1990s. The resolution of the crisis was greatly facilitated by a tripartite consensus proposed by the government. The first step was to reach agreement on the country's long-term development strategy. To achieve this goal, bipartisan commissions were established in the legislature that were able to agree on a long-term development strategy. The second step was to complement this with a twenty-year plan by the Ministry of Trade and Industry in 1993 to develop eight productive clusters, with broad-based support from employees and employers, thus defining a new industrial policy. The third step was to centralize salary negotiation, managed as part of a national agreement that was able to support a historic salary freeze in 1992 and 1993.

This broad-based social consensus was the basis for sustaining a profound and rapid productive restructuring that the country went through after the crisis. As a result, exports with a high technological content started leading national growth. Prior to the productive restructuring, in 1990, Finnish exports were mainly from the forestry sector and the paper industry (40 percent of the total). By 2004, those two industries represented only 20 percent of the total while exports from the electrical machinery and information technology industry grew from 8.5 percent in 1990 to 24.4 percent in 2004. Through the restructuring, Finland became more open and competitive in the world economy, with the volume of trade (imports and exports as part of GDP) increasing from 47 percent in 1990 to 59 percent in 2006.

At the same time, the Finnish government achieved a broad-based social consensus to support the process of admission into the European Union, which it had formally requested in 1992, in mid-crisis. EU membership induced an additional internationalization of domestic firms and also succeeded in attracting massive amounts of foreign direct investment to the Finnish economy.

The Irish case is more mixed. In Ireland, poor economic performance prior to 1987 created the conditions for the first Social Partnership Agreement, a new institutional modality to seek broad support for tough adjustment policies. The 1987 Social Agreement covered 1988–1990 salary adjustments in both the private and public sectors. The pact limited annual salary growth to 2.5 percent for the period, while inflation was no less than 3.5 percent a year (see table 6). Meanwhile, tax reform considered in the pact was passed in 1988 and took effect in 1989. The main aspect of this reform was a cutback in marginal tax rates for households. The maximum rate of 64 percent in 1984–1985 was reduced to 56 percent as part of the Social Agreement. A moderation in salary increases plus the cut in personal income tax allowed household incomes to increase in real terms.

An economic boom followed. Unemployment, which had reached 16 percent in 1986, fell to 4 percent in 2000. Annual growth in the export of goods and services increased from 8.3 percent in 1980–1989 to 14.7 percent per year in 1990–2000, and the overall economy grew close to 7 percent a year in the same period (table 6).

The case study of South Korea is also interesting. After the crisis of 1997–1998, the country began a labor reform that was based on a consensus between employers, the government, and employees. The "Joint Tripartite Statement on the Fair Way to Share the Burden in the Process to Overcome the Economic Crisis" was the first tripartite reform to be negotiated. It consisted of a detailed social pact that was to make the labor market more flexible in order to restore competitiveness.[17] This was accompanied by other reforms in the financial sector (among them creation of agencies in charge of financial regulation and oversight, and increased reserve requirements) and the business sector (requirements to improve management transparency and accountability). These reforms bore fruit. From 2000 to 2008, the South Korean economy grew at an annual rate of 5.3 percent, with exports increasing their share of GDP from 32 percent in 1997 to 53 percent in 2008 (table 5).

Social and political consensus reached by Finland, Ireland, and South Korea at critical points during economic crisis proved to be a key factor for restructuring and modernizing their economies. During the current crisis in periphery countries in Europe, consensus has been absent, thus prolonging the period of very slow growth rates and high unemployment.

In summary, social and political consensus reached by Finland, Ireland, and South Korea at critical points during economic crisis proved to be a key factor for restructuring and modernizing their economies. By contrast, during the current crisis in periphery countries in Europe, consensus has been absent, thus prolonging the period of very slow growth rates and high unemployment.

How Relevant Are These Lessons for Middle-Income Countries?

The previous section identified some of the lessons learned from countries that made a successful transition from middle-income economies to advanced economies. What do these experiences suggest regarding the postcrisis agenda that middle-income countries should pursue?

Good macroeconomic management during the crisis is not enough.

Adequate macroeconomic management on the part of the majority of middle-income countries allowed them to avoid being dragged into the profound financial crisis along with developed economies. East Asian and Latin American economies accumulated international reserves, reduced their public debt as a proportion of GDP, and implemented a countercyclical fiscal policy, saving a significant part of the additional revenue generated by the rapid expansion of their economies in the boom period preceding the crisis.

As to whether this solid macroeconomic situation can be maintained in the postcrisis phase, two types of risks could emerge. The first is paradoxically associated with successful handling of the crisis. Middle-income countries show positive current and projected indicators on economic growth, balance of payments, and fiscal balance, in addition to having moderate public debt, especially when compared to that of advanced economies. This situation of relative strength in macroeconomic indicators has begun to attract massive sums of external capital, a process that is reinforced by the low interest rates and, in some cases, the excess liquidity generated by a policy of quantitative easing in developed economies as is the case with the U.S. economy (see table 10).

The other type of risk occurs with a flexible exchange rate. Increased capital inflows cause the exchange rate to appreciate and stimulate an expansion in internal credit to consumers and sectors such as construction. This in turn leads to excessive domestic spending and renewed inflationary pressures. Should this trend continue, the main risk is well-known: a boom fed by excessive demand and by public and private overindebtedness. What necessarily follows is a recessionary adjustment like the one that the majority of advanced economies are going through today. In spite of a flexible exchange rate as compared to a fixed rate in the eurozone, the risk of a boom-bust cycle has not been eliminated.

Reducing that risk entails anticipating an eventual accumulation of economic imbalances. A countercyclical fiscal policy would help to restore balances. In this scenario, it would require a cut in public spending or higher taxes—the most widely used tool for dealing with excessive internal demand. But that could prove insufficient if the problem is not attacked at its root:

Table 10. Capital Inflows (% of Total)

	2009	2010	2011
Asia (% of total)			
Foreign direct investment	46.1	34.1	35.5
Portfolio investment	24.7	28.5	27.0
Other investment	29.2	37.4	37.4
Latin America (% of total)			
Foreign direct investment	39.3	36.2	39.7
Portfolio investment	39.9	24.0	21.9
Other investment	20.9	39.8	38.4

Source: Author calculations based on Institute of International Finance the uncontrolled expansion of credit induced by excessive capital inflows in the economy. In such a case, countercyclical capital account management is needed. The capital coefficients required of banks must be increased during the expansionary phase, as must the provisions required to handle bad loans. Capital controls is another instrument that should be considered in this setting.

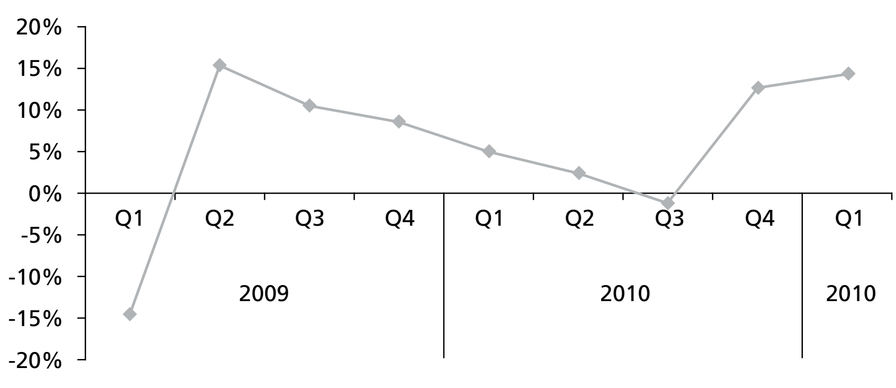
The recent debate on these issues always concludes with the need to implement "macroprudential measures," but the degree of implementation of these measures or their specificity is clearly still not enough. It neither eliminates nor substantially reduces the risk of a boom-and-bust cycle. Economies like those of Brazil, Chile, Peru, and Colombia are faced with this dilemma and have not yet managed to find the formula to resolve it. In fact, the most recent IMF report warns of excessive credit expansion in countries such as Brazil and Peru, accompanied by inflationary pressures and the possibility of a boom in the price of assets.[18]

The postcrisis macroeconomics of middle-income countries will require increasing the number of instruments needed to stabilize their economies without compromising their future economic growth rates.

This kind of risk can be made worse for economies that are exporters of commodities. Their prices are at their highest levels, a situation in which the demand in China and other Asian countries plays a major role (see figure 3). If the abnormally high revenue that commodity exports generate is not neutralized with increased reserves or savings in the form of sovereign funds, then the macroeconomic imbalances will tend to be exacerbated.

In summary, the postcrisis macroeconomics of middle-income countries will require increasing the number of instruments needed to stabilize their economies without compromising their future economic growth rates. A flexible exchange rate helps but is not enough. Among these additional instruments, countercyclical management of the capital account should play a fundamental role, along with instruments as heterodox as allowing capital inflow controls in boom periods. The creation of sovereign funds to save part of the additional

Figure 3. Quarterly Growth in Commodity Prices



Source: Author calculations based on IMF data revenue generated by abnormally high commodity prices is also an essential instrument for the macroeconomic stability of countries whose exports are highly concentrated in natural resources and raw materials, as is the case with the majority of South American economies.

In addition, effective domestic and across-the-border regulation of bank and nonbank credits, along with careful measures to avoid overindebtedness, is a task that is still pending for middle-income countries, as well as for several of the advanced economies whose trajectories are described in the preceding section. The current financial crises in Ireland, Spain, Portugal, and Greece confirm beyond all doubt that these economies lack adequate regulation of financial flows.

Eliminating excessive rigidity in the labor and exchange markets is required to stay competitive without compromising growth.

Making a fixed exchange rate an essential part of the rules agreed to for economic integration, as it was when deciding to create the eurozone, has introduced excessive rigidity to the process of adjusting economies subjected to external or domestic shocks. In these situations, devaluation of the exchange rate is not an available option, and all adjustments must be made by cutting real salaries, reducing public and private spending, or raising taxes. The political and practical difficulties of achieving tangible and rapid results that stabilize these economies and allow them to regain their competitiveness have been made self-evident with the experiences of Greece, Spain, Portugal, and Ireland during the current crisis.

The financial crises in Latin America in the 1980s and in East Asia in the 1990s were severely aggravated by an excessively rigid exchange rate policy.

Experience with fixed exchange rates pegged to the dollar or to a basket of currencies has not been positive for Latin American or East Asian countries either. The financial crises in Latin America in the 1980s and in East Asia in the 1990s were severely aggravated by an excessively rigid exchange rate policy.

The other market whose rigidity aggravates problems such as a loss of competitiveness in developed economies as well as middle-income ones is the labor market. In the cases studied here, two types of impacts were observed as a consequence of an excessively rigid and regulated labor market. The first is that of an upward trend in salaries regardless of the economic cycle, driven by the segment of highly organized workers whose jobs are de facto guaranteed due to union pressure and the high cost of firing workers. These organized workers have a significant capacity for disruption through the unions that represent them. This is the case in the peripheral economies of Europe. In these cases the adjustment is produced through en masse layoffs of nonunionized workers and those with temporary work contracts. Spain, with unemployment exceeding 20 percent of the labor force, is a clear example of this alternative.

A less rigid and less segmented labor market would allow for economic adjustments to be implemented more swiftly and with less of a negative impact on employment. This requires reforms that lead to a convergence on the type of work contracts, cutting the cost of layoffs but increasing and improving unemployment insurance and other forms of social protection for both the formal and informal segments of the labor market.

Judging by the experience of the countries examined here, the prospects regarding the political and social viability of implementing reforms to make the labor market more flexible are not very good, unless a collective awareness of a "national crisis" pushes the different actors to agree to an agenda of change that includes the labor market.

It is impossible to remain competitive in global markets without making massive investments to improve the quality of human resources and the economy's capacity to innovate.

The most successful cases among the countries analyzed are the ones that have invested more and earlier to improve the coverage and quality of education on all levels. Finland and South Korea, in addition to Ireland, are also the ones that were the most successful in creating public and private institutions to foster greater innovational capacity in their economies. Tables 11 and 9 illustrate

Table 11. Ranking (PISA Test 2009) and Ranking in Higher Education and Training

	Ranking in Mathematics	Ranking in Sciences	Ranking in Reading	Ranking in Higher Education and Training
Finland	6	2	3	1
Ireland	32	20	21	23
Portugal	33	32	27	39
Spain	34	36	33	31
South Korea	4	6	2	15
Malaysia	—	—	—	49
Thailand	50	49	50	59
Argentina	55	56	58	55
Brazil	57	53	53	58
Chile	49	44	44	45
Colombia	58	54	52	69
Mexico	51	50	48	79
Peru	63	64	63	76
Uruguay	48	48	47	40

Source: PISA (OECD Programme for International Student Assessment) 2009 in Ranking in Mathematics, Sciences and Reading. Ranking in Higher Education and Training from The Global Competitiveness Report 2010–2011 the argument by comparing rankings in educational quality and spending, as well as the investment in research and development in the developed countries, with those of selected middle-income countries.

The indicators shown in the tables confirm the huge gaps that continue to separate advanced economies from middle-income countries in their investment in human capital and innovation. The existence of these gaps and the difficulty in closing them are among the factors that could cause some middle-income countries to fall into the middle-income trap, a situation that would make it more difficult for them to progress toward advanced economies in the next decade.

The transition to an innovation economy will require a highly qualified workforce as well as constant and increased spending on innovation and development.

In effect, the transition to an innovation economy will require a highly qualified workforce as well as constant and increased spending on innovation and development. These are central issues on the future agenda of middle-income countries.

The capacity to forge across-the-board agreements to undertake the transformations required to become advanced economies is what makes the difference between the success or the stagnation of this process.

As described above, in moments of deep economic and social crisis, Finland, South Korea, and Ireland have managed to create the conditions for installing across-the-board negotiations that resulted in broad-based agreements not just to deal with the crisis, but also to make the changes that their economies required to start a "good boom": high economic growth, export dynamism, and a significant drop in inflation and unemployment.

Ireland managed this transformation starting in the late 1980s with the Social Partnership Agreements, which were renewed every three years. Finland made progress on cross-cutting political agreements during the first half of the 1990s to deal with the collapse of its main market—that of the Soviet Union—and the overheating of its economy in the previous stage. South Korea managed to reach agreements between the private sector and organized workers to deal with the Asian financial crisis in the late 1990s. The result was greater economic openness, moderating salary increases, and a significant expansion of social security networks, which before the crisis provided scant coverage in South Korea or other East Asian countries.

The most complex challenge for middle-income countries in the future will be reaching basic across-the-board and bipartisan agreements to move toward more efficient and competitive economies. Experience shows that the space to negotiate transformational agreements for an economy is facilitated, paradoxically, when both society and actors in the political world perceive that the crisis has become a "negative sum game" in which everybody loses if they do not contribute to finding a way out of it.

The problem is much more complex when the situation is the opposite, that is, when the prevailing perception is that of well-being associated with an economy that has successfully overcome a financial crisis and is growing at rates that are more than reasonable. Agreements on transformations needed to prolong the boom over time are more difficult to achieve and occur less frequently than those reached as a consequence of an economic collapse caused by imbalances accumulated during the rapid expansionary phase.

Successfully traversing the path for middle-income countries to become advanced economies supposes a more complex phase of uninterrupted microeconomic reforms and reforms that continually improve the quality of human resources, their investment decisions, and their capacity to add value and to diversify products so they can compete internationally.

The problem is that all reforms entail costs for one party or another, especially for those who will potentially lose in terms of income, power, or status caused by the changes in the structure of the economy. How these costs will be shared is the underlying issue in the negotiation of across-the-board agreements.

The current experience of countries from the European periphery is diverse in terms of the capacity to forge agreements to deal with the crisis and the post-crisis. In Ireland and Portugal, the lack of agreements has led governments to fall. By contrast, in the Baltic countries, governments have been reelected with massive support in spite of the fact that these governments are undertaking profound structural changes with a high social cost.

Gaining a better understanding of when the second outcome becomes more likely than the former is a fundamental challenge for middle-income countries, not just to avoid the middle-income trap, but also for them to continue on the path of accelerated growth. The quality of politics and the capacity to reach consensus will doubtlessly help lead to a successful second outcome.

Notes

1 The main criteria that the IMF uses to define advanced and developing economies are per capita income level; diversification of exports; and degree of integration in the global financial system.

2 We have defined middle-income countries as those whose PPP per capita income (in constant 2008 dollars) is $8,000 to $23,000.

3 This is a general description of economic transition. But there are exceptions. China, for instance, is on the verge of entering the category of middle-income country. Its vigorous and emergent capital-intensive sector is developing parallel to the strong labor-intensive industries that absorb the abundant labor available in rural areas.

4 Michael Schuman (2010), World Bank (2010), Eva Paus (2011), Wing Thye Woo (2009).

5 The transition is determined to be from $15,000 PPP until the $23,000 PPP threshold has been reached.

6 See more details in Patricio Meller, Andrés Liberman, and David Rappoport (2009); Jari Ojala, Jari Eloranta, and Jukka Jalava (2006); Jaakko Kiander and Antti Romppanen (2005): Jaakko Kiander (2004); Torben Andersen, Bengt Holmström, Seppo Honkapohja, Sixten Korkman, Hans Tson Söderström, and Juhana Vartiainen (2007); Seppo Honkapohja, Erkki Koskela, Willi Leibfritz, and Roope Uusitalo (2009); Thorvaldur Gylfason, Bengt Holmström, Sixten Korkman, Hans Tson Söderström, and Vesa Vihriälä (2010); and Anders Aslund (2010). See data in table 4.

7 The Bank of Finland is the central bank of the country. The Bank of Finland is subordinated to the Parliament of the country.

8 Finland's educational and innovational reform is described in the "Useful Lessons" section below.

9 See more details in Patricio Meller, Andrés Liberman, and David Rappoport (2009); Alice Amsden (1989); Ajai Chopra, Kenneth Kang, Meral Karasulu, Hong Liang, Henry Ma, and Anthony Richards (2002); OECD (2008, 2010); Korea Economic Institute and the Korean Institute for International Economic Policy (2009); and Deok Ryong Yoon (2011). See data in table 5.

10 Justin Lin (2009).

11 For example, troubled financial institutions were to be closed, or, if they were deemed viable, restructured, and/or recapitalized. To establish prudential regulations and supervision of the financial sector, various measures were listed with target dates. All banks were required to meet the minimum capital ratio of 8 percent and encouraged to increase their capital ratio to 10 percent by December 2000. Accounting standards and disclosure rules would be strengthened to meet international practice. Financial statements of large financial institutions would be audited by internationally recognized firms. The Financial Supervisory Commission was created in April 1998 and entrusted with the supervisory power over all financial entities and markets, and the authorities were to play a central role in the financial sector restructuring. Likewise, corporate restructuring was required. The transparency of corporate balance sheets was ensured by enforcing generally accepted accounting practices. Measures were worked out and implemented to change the system of mutual guarantees within chaebol groups. Also some measures to reduce the high debt-to-equity ratio of corporations were implemented. It was declared that the commercial orientation of bank lending would be fully respected and that the government would not intervene in bank management and lending decisions. Lastly, steps were taken to increase labor market flexibility. Reform of the financial and corporate sector required greater labor market flexibility. Accordingly, a Tripartite Commission facilitated agreements on layoffs, pay cuts, and reduced overtime and bonuses. Labor laws were amended in February 1998 to allow firms to lay off redundant workers in cases of urgent managerial need.

12 Based on data provided by the IMF, the World Bank, and the World Trade Organization.

13 See more details in Ignacio Briones (2009); Lucio Baccaro and Marco Simoni (2004); Frank Barry (2003); Nicholas Crafts (2005); Jānis Malzubris (2008); John Cotter (2009); Patrick Honohan and Philip Lane (2009); Morgan Kelly (2010); and Bennett Stancil (2010). See table 6.

14 Ireland's educational and innovation reform is described in the "Useful Lessons" section below.

15 See details in Sebastian Saiegh (2009); Carmela Martin (2000); European Commission (2005); Matilde Alonso Pérez and Elies Furio Blasco (2010); Uri Dadush and Vera Eidelman (2010); and Sebastián Royo (2007).

16 See details in Carlos Pereira and Shane Singh (2009); Orlando Abreu (2006); Pedro Cardoso (2004); Pedro Lains (2004, 2006); and Shimelse Ali (2010).

17 For example: job security measures to deal with unemployment, expansion of social security cooperation between labor and management for basic labor rights, and flexibility of labor market.

18 IMF (2011).

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