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"Security, economic growth and the middle income trap"

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Security in the 21st century is not restricted solely to the military and foreign policy realm, but it has many facets. Security certainly relates also to economic growth, innovation and progress, to the avoidance of stagnation and the provision of an adequate quality of life for today's and tomorrow's generations. To ensure that individuals feel safe and secure in the world of today, security in all its manifestations must be provided.

Security in the sense of quality of life and economic progress has become increasingly harder to provide for. The financial crisis has weakened our economies. The world is also constantly changing. New actors are entering the global scene. Globalisation is transforming supply and demand patterns. We are no longer confronted with the typical Chinese producer-transatlantic consumer model. In the face of the changing world, individuals must feel empowered and secure. This is a challenge, with ever more uncertainty about the future and novel risks materializing every day.

In emerging economies of Central and Eastern Europe, one risk worth mentioning in the context of providing economic security and a decent quality of life is that of the middle income trap.

The trap refers to growing economies which end up stagnating at middle-income levels and fail to graduate into the ranks of high-income countries.

Economies often get stuck in between as they do not have access to the best technologies (reserved to rich economies) and over time also lose the advantage of lower wages (reserved to the poorest ones). This is where CEE economies are now. Economies which usually get caught in the middle income trap are those with per-person incomes of \$10,000-11,000 and \$15,000-16,000 a year. It is important however to distinguish between growth slow-downs related to middle incomes and slowdowns provoked by other factors. The economic climate of the time is one key factor upon which growth hinges. For instance, the 1970s economic climate was particularly challenging for global growth, specifically the oil-price shock years, 1973 and 1979, stand out. This reminds us that the global conjecture can be as important as an individual country's level of development when it comes to growth. Thus one must be careful before labelling an economy as suffering from the middle-income trap. It might just be that the economy in question is only feeling the strain of the global environment. This holds particularly true in the current economic context, when slow global growth is a fact.

One more caveat must be kept in mind before concluding that an economy is at risk

of falling into a middle-income trap, namely that often economies undergoing rapid structural change face a concomitant risk of slowdowns. During the process of economic development, surplus labour typically moves from the agricultural and services sector to formal employment in the newly expanding industrial sector. As agriculture and services shrink in relative terms, industry expands and modern growth ensues. This process however can create risks of a growth slowdown which would not occur in an economy trapped in a low-equilibrium with no structural transformation and no growth.

These caveats should however not make policymakers complacent about the threat of a middle income trap, which is slowly being discussed in the context of the CEE area. Typically, such a trap materializes after the growth benefits of labour and capital productivity are exhausted and the focus should shift more on innovation and does not. And it is indeed the case that since the 90s, countries such as Poland, the Czech Republic, Slovakia and Hungary have used labour and capital productivity increases as their main growth drivers.

The worry now is that these countries may slowly exhaust the benefits derived from traditional growth drivers and may need to make the leap onto new innovation frontiers. The risk however is that they may not be ready for this leap, lacking the adequate innovation capacity and resources. The worry of the trap materializing is also accentuated by an ageing population, by low private sector confidence and consequently low investment.

Whether Central Europe is actually at risk of a middle-income trap, going through a rapid restructuring with negative growth side-effects or simply feeling the burden of a difficult global environment, we cannot deny the importance of kick-starting growth.

How can Central Europe avoid falling into the middle income trap and promote sustainable growth? New member states of the European Union can be seen as having at their disposal two options for growth: one is growing convergence in living standards, a second is working on a home-grown growth model with different measurements and stronger incentives for progress.

A tailor made, home-grown plan is likely to be more successful in avoiding the middle-income trap. What kind of home-grown model could we expect to have in Central Europe?

To understand this model, it is useful to look at the evolution of the transition economies ever since the fall of communism.

When 25 years ago, individuals and societies of Central and Eastern Europe embarked on a grand change towards democracy and market economy, they found themselves in a new democratic reality with their enormous consumption ambitions based largely on very traditional patterns. And those came from the West.

But also, they inherited an economy where investment had never cared about the environment, about resource efficiency, about energy efficiency or quality of life.

The first years of transition were years of a dramatically deep recession, of sky rocketing inflation, of inequalities growing between winners and losers of transition. Those societies moved quickly on catching up but they are still emerging economies, with higher growth rates than in countries around, growing income and consumption hunger with all its consequences.

Even today still many people believe in this path for change, where first you grow and later you go green, and sustainable, and start caring about the externalities of growth.

We do face however gradually growing individual and collective feeling of responsibility for sustainability of development and of solidarity with future generations and this is increasingly linked to the desire of looking anew at their own life quality.

The current economic crisis has added a new dimension to the growth challenge and to the middle-income trap.

More specifically, with increased pressure on the sustainability of public finances, additional strain is put on individuals for ensuring their own prosperity; this will partially be achieved through education and skills which enable social mobility.

Thinking of a home-grown growth models to be pursued by Central Europe in the future, we could certainly envisage a strategy focused on quality of life, sustainability, education and innovation.

The home-grown growth model can certainly exploit a country's competitive advantages, while also bearing in mind the policies identified by researchers and policymakers up until now as helping against the middle income-trap.

These policies all relate to a holistic outlook on competitiveness. The latter includes a number of elements. One is given by efficient institutions. Governments need to build and operate successful institutions, with adequate property rights, economic freedom and effective enforcement; good quality institutions can stimulate an entrepreneurial culture, combining good quality institutions with an entrepreneurial culture, which nurtures and protects innovators.

Another is given by quality infrastructure. A good macroeconomic environment also matters. Prudential regulation to limit the build-up of excessive capital inflows is important as it cushions the impact of a potential sudden stop. Such inflows are usually conducive to growth and allow capital to be allocated wherever its marginal product is highest, however significant capital inflows can also be followed by sudden stops. Moreover, high reliance on cross-border banking flows can have negative spillovers in the case of a downturn.

Additionally, competitiveness is also driven by demography. Tackling demographic challenges is of the essence. Policies which could be pursued include combating gender discrimination, providing education on sexual and reproductive health etc.

If the endeavour to boost growth is to succeed however, all of the above policies will have to be placed in the global context. National and European level competitiveness can only to be measured against the global background.

This brings me to the importance of the new industrial revolution we are experiencing today, focused on the globalisation of services.

In the face of lower transport costs, services are characterised by a growing tradability and constitute a rich source of growth. This holds particularly true of digital services, such as education, health, insurance, audits, call centres.

The pace of productivity growth in services has begun to outpace that of manufacturing. This highlights one potential way out of the middle-income trap, namely shifting emphasis away from traditional low productivity sectors and towards high productive modern sectors.

In countries susceptible to the middle-income trap, or already caught by it, it is often the case that a disproportionate emphasis is placed on the traditional manufacturing sector, with the result that a potentially higher productivity sector, such as that of modern services, ends up being neglected. A way to resolve this can involve the pursuit of structural reform which enables an economy to make the transition to higher productivity production in both goods and services.

Many policies can be pursued in order to achieve this goal. They include the promotion of innovation, education, as well as attracting highly productive foreign firms to locate production in the respective economy. More can also be done to promote venture capital for small domestic start-ups, which could eventually plug themselves into global markets.

As we have seen, opportunities to escape the middle income trap abound, policymakers now need to make wise use of them. By avoiding the middle income trap, we will get one step closer to creating a feeling of safety and security to our citizens. People will feel more empowered in the face of a messy and ever-changing global world and will have more confidence that their quality of life will be adequately provided for today and in the future.