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*Upfront*

# Sustaining Industrial Development in the South

RICHARD KOZUL-WRIGHT AND PIERGIUSEPPE FORTUNATO

ABSTRACT *This article discusses how active industrial policy and south–south coordination mechanisms can facilitate the strategic insertion of developing economies in the global markets and production networks. It proposes an integrated approach to trade, investment and industrial challenges and stresses the importance of political leadership and effective governance structures.*

KEYWORDS *structural transformation; industrial policy; south–south cooperation and middle-income trap*

## Introduction

Developing countries face several major and interconnected challenges in their pursuit of a new and ambitious sustainable development agenda. Success in achieving much of this agenda will depend on high rates of investment and a shift towards higher productivity activities. For most countries, this implies not only sustaining the fast pace of growth achieved in the first decade of the new millennium but also a big push on the industrial development front.

Rapid growth in the 2000s took place under very favourable global conditions, fuelled by rapid private credit growth in the developed economies, especially in the USA, with positive spillovers on developing economies through increased exports, low-cost capital and rising commodity prices. These favourable conditions, however, are mostly gone raising a great deal of uncertainty about the prospects for continued catch-up growth (Akyuz, 2013; UNCTAD, 2014).

The 2000s also saw a strengthening of south–south economic ties, underpinned by a transformation in the composition of southern exports from primary commodities to manufactures (UNCTAD, 2015). These developments helped to encourage the idea that developing country growth had 'decoupled' from trends in the advanced economies, with a good deal of expectation invested in the large emerging economies. This idea has also lost much of its earlier enthusiasm.

The problem stems, in part, from a false aggregation. The so-called BRICS economies, for example, are a very diverse group with very different growth potential and linkages to the global economy; a number are currently in, or close to, recession, and their longer-term growth prospects have diminished. Most of the rise in manufacturing production and trade, both from a global or south–south metric, has

taken place in the newly industrializing economies (NIEs) and China and linked, in part, to their participation in international production networks. By contrast, the share of other developing regions in world manufacturing production and exports over the past two decades has either not grown or has fallen back. Moreover, despite the rapid growth in manufacturing exports from East Asia, the value added in their production has not increased as significantly (UNCTAD, 2015).

These developments have given rise to concerns of a 'middle-income trap' in which developing countries are struggling to upgrade to higher productivity activities and more sophisticated exports, and to create decent employment particularly in the urban sector. To find a path that is sustainable and leads to economic convergence, developing economies will need to forge a new and more balanced development model in which they increasingly draw on domestic sources of demand as new engines of growth and promote structural transformation through active industrial policies. In this article, after sketching patterns of economic convergence over the post-war era, we will briefly describe how some East Asian economies escaped the middle-income trap and offer some possible building blocks of a new sustainable development strategy.

## Uneven development and the middle-income trap

The identification and comparison of long-term growth trends across broad country groupings such as developed and developing, or north and the south, are not a straightforward exercise. This is partly because of data problems, partly because of subtle breaks in trend which can nevertheless have significant cumulative effect over a long period of time and partly because of idiosyncratic influences at the country level, including the fact that some countries (principally the first-tier East Asian, NIEs) have graduated from developing to developed country status at different points in time while, at the same time, one or two larger developing economies have a significant impact on the aggregate figures. Despite these difficulties, it is possible to identify several stylized facts linked to the idea of economic convergence over the last half-century.

First, the performance of the world economy has been dominated throughout this period by trends in the developed economies. The world economy achieved unprecedented real GDP growth rates in the 1950s and 1960s, driven by strong growth in the USA and even stronger growth in Western Europe and Japan. Global growth has slowed down steadily since then in large part because these same economies have been steadily slowing down.

Second, while economic growth did accelerate in all developing regions after the Second World War and several developing countries began catching up with the developed economies, the fast growth in most developed countries during their post-war 'golden age' resulted in the average income gap between north and south widening considerably; and even as growth in the north slowed, growth collapses during the 1980s and 1990s in many developing countries often saw these gaps grow wider still.

Third, the only developing region to maintain a strong and sustained development dynamic across the last half-century or so was East Asia, overtaking Latin America as the wealthiest region in the developing world and closing the income gap with the developed world. The roots of this success go back to a strong investment push and related industrialization drive in the 1960s and 1970s, bolstered by dynamic gains linked to closer regional trade and investment flows, which emerged in the 1980s (UNCTAD, 1996, 2003). The overall soundness of this development strategy was confirmed in the 1990s, as China embarked on a similar big push and export drive.

Fourth, despite localized successes, all developing economies have witnessed periodic growth setbacks during the past 50 years, and in some cases of a deep and prolonged nature and oftentimes the result of shocks and policy changes in the developed economies.

The overall cumulative impact of these trends is that the great majority of countries which were in the first quintile of the world income

distribution in the early 1960s remain in that position today and, analogously, most of the countries placed in the bottom quintile remain in the low tail of the distribution or, at most, moved up to the middle. Although economic growth in the last decades has lifted some low-income countries from poverty to a middle-income levels, and the recent combination of a Northern slowdown (and crisis) and a burst of Southern growth has stabilized or slightly improved the global distribution of income (Milanovic, 2016), very few among them have been able to catch up with the high per capita income levels of the advanced economies and stay there.[1] Furthermore, the frequency of prolonged periods of stagnation or recession (growth slowdowns) in the post-war period seems to be much higher in middle-income than in low- or high-income countries (Aiyar *et al.*, 2013).

This pattern has raised concerns of a 'middle-income trap'.[2] There is no consensus on the underlying causes (Kanchoochat, 2015), indeed on whether growth slowdowns in middle-income countries are best described as a 'trap' (Eichengreen *et al.*, 2013). However, there is agreement that standard Solovian models of economic convergence are not very helpful for understanding growth dynamics in middle-income economies and that the challenges they face in climbing the development ladder appear more difficult today than for industrializers in the late nineteenth and early twentieth centuries (Arias and Wen, 2015).

Following Felipe (2012a), we compute a measure of income gap as $GAP = 1 - (Yi/YUS)$, where $Yi$ denotes the income per capita of a country $i$ and $YUS$ the income per capita of the USA (taken as a proxy of high-income countries performance). Figure 1 depicts the correlation between our measure of income gap with respect to USA computed in 1990 and in 2014. The existence of a clear positive correlation suggests that those economies that were more distant from the income frontier in 1990 tend to remain more distant in 2014. Most developing economies did not show any sign of strong convergence with US economy.

Figure 2 shows the rate at which GAP changed during the period 1990–2014 against the GAP in 1990; a negative rate means that the country has reduced its GAP with the USA, and a positive rate implies that the country's GAP with the USA widened during 1990–2014. The figure looks at those economies at low and middle levels of income in 1990 and shows that, contrary to what would have been predicted by the convergence hypothesis, there is no sign of negative correlation between the initial gap and its growth rate. For the great majority of countries, the relative income gap has remained fairly constant in the last quarter of century.

## Escaping the middle-income trap: East Asian experiences

Historically, economies that have successfully escaped the middle-income trap have practiced 'adaptive efficiency' (North, 2010), the capacity to develop institutions, both private and public, that provide a stable framework for economic activity but at the same time are flexible enough to create the space to undertake policy experiments and make choices in response to unforeseen shocks and specific conjunctural challenges.

Arguably, the challenge of building effective institutions and designing appropriate incentives and disciplines to raise the rate of investment and direct it towards more productive activities has been greater the later countries have embarked on a sustained process of economic development, requiring a more prominent role for the state in mobilizing resources for building industrial capacity and turning its potential into sustained and rapid rates of growth (UNCTAD, 2003). Certainly, the pace of capital formation needed to kick-start and sustain a period of successful catch-up growth has been on a rising trend over the post-war period, as has the size of the traded goods sector required to integrate effectively into a more open and interdependent global economy.

Managing the processes of a big investment push, economic diversification and strategic integration has, over the decades, depended more on the adaptation of a familiar set of macroeconomic, industrial, educational, financial and trade measures to a set of goals that have themselves evolved with each new stage in the

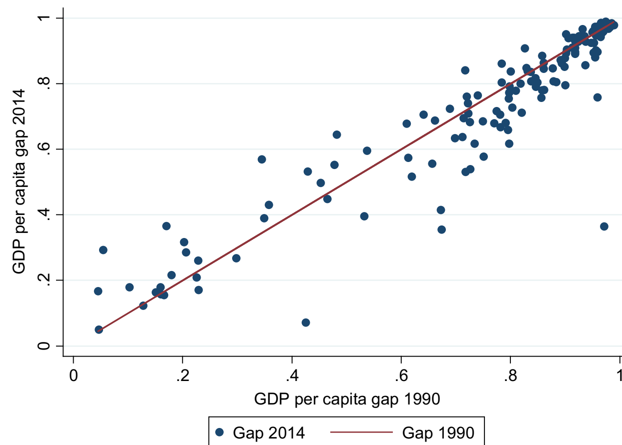


**Figure 1:** GDP per capita gap: 1990 and 2014. *Source*: Authors' calculations

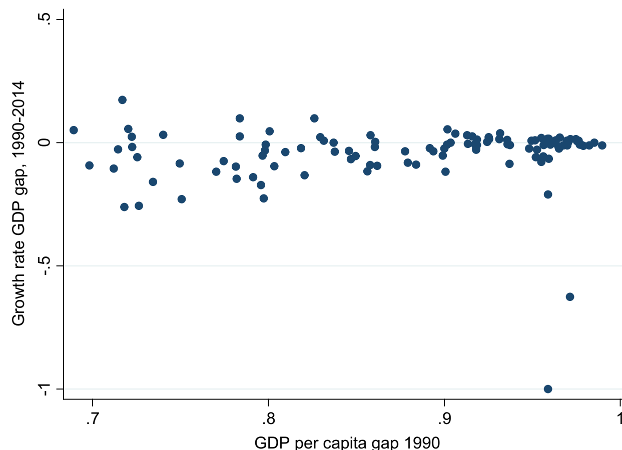


**Figure 2:** GDP per capita gap growth rate. *Source*: Authors' calculations

development process rather than on the invention of a new set of policy instruments. A cocktail of such active policy measures was certainly used in the successful post-war East Asian development models to stimulate and sustain a strong 'profit-investment-export nexus' (UNCTAD, 1997, 2003). However, as Cohen and de Long (2016) have argued, the US developmental state had pursued many of the same measures over the course of its own economic rise.[3]

The East Asian developmental states enjoyed a particularly favourable external environment thanks to a combination of strong global trade, repressed international financial markets, extensive policy space (thanks to the multilateral settlement at Bretton Woods) and a series of advantages linked to Cold War geopolitics, all of which made building locally owned and controlled industrial sectors easier. However, such circumstances did not automatically translate into catch-up growth—effective state action was critical.

The developmental states of East Asia saw their task as increasing the supply of investible resources and socializing long-term investment risks. State-sponsored accumulation involved

variously the transfer of land and other assets, efforts to ease competition in some areas while increasing it in others, control of the financial system, a pro-investment macroeconomic policy, including direct public investment in some lines of activity. But critically, these developmental states did not simply measure success in terms of raising investment to fuel economic growth, but also in terms of guiding investment into activities that could sustain a high-wage future for their citizens. This meant a coordinated effort to shift resources from traditional sectors by raising agricultural productivity and channelling the resulting surplus to emerging industrial activities (Grabowski, 1998; Studwell, 2013). It also meant deliberately reducing risks and augmenting profits in industries deemed important for future growth (Wade, 1992; Amsden, 1995). Like their late nineteenth- and twentieth-century precursors, this meant making full use of the creative impulses of global markets, even as some domestic producers were being protected against excessive competition, through a strategic integration with the international economy.

There is broad agreement that 'governing the market' in this way required a capable coherent bureaucracy, closely connected to but still independent of the business community. This was not an innate feature of a country's culture or history but rather the outcome of reforms to bureaucratic agencies over a relatively short time, which created lead agencies, strengthened the role of technocratic policymakers and rejuvenated the way in which bureaucracies dealt with counterparts in the private sector. The establishment of meritocratic recruitment, achieved through a variety of means, along with a career structure that could produce rewards commensurate with the private sector, was important features of building these effective bureaucracies (Evans, 1995; Evans and Rauch, 1999).

Various scholars (Campos and Root, 1996; Doner and Schneider, 2015) have also highlighted the role of business–government councils. These councils served to reconcile divergent interests, coordinate expectations and facilitate and monitor policy implementation. A set of ideal characteristics of public–private collaboration have been drawn from successful models such as the Korean export council (Doner and Schneider, 2015). These included *regular meetings* which provided a reliable flow of information and established a lasting relationship; *authority to allocate* resources using measurable targets which allowed for monitoring of both sides of the bargain; *technical staff* drawn from both ministries and well-funded business associations with a clear understanding of the problems involved.

Arguably, the critical step in forging an effective government–business relationship, and often the misstep, is the provision, monitoring *and* disciplining of rents in support of structural transformation and upgrading. (Khan and Sundaram, 2000; Kahn, 2007). Amsden (2001) coined the term 'reciprocal control mechanisms' to refer to a set of institutions that can discipline the recipients of rents based on feedback that has been collected and assessed. Such mechanisms essentially involved the design and use of performance standards as a metric against which to assess whether and to what extent firms have fulfilled their side of an industrial policy bargain. Such standards could be linked to subsidies, trade protection, access to credit and could reciprocally involve export performance, local content requirements, management practices, R&D spending, etc. Korea and Taiwan, China, are often presented as the archetype users of such mechanisms. Indeed, many studies have made a distinction between the relative success of industrial policy in north-east and south-east on the more limited capacity of state actors to discipline their private-sector constituents (Studwell, 2013).

## Towards a new development strategy

Efforts by today's developing countries to upgrade, diversify and catch-up are taking place in an interdependent but uneven world economy where earlier industrializers have already accumulated a significant stock of capital and capabilities (at the human, firm and social levels) that give their producers cost and productivity advantages on both domestic and international

markets, as well as equipping them to advance the technological frontier. Closing these gaps is made all the more challenging because policymakers are chasing a moving target with the continuing growth and evolution of richer countries. On several dimensions, such as years of schooling or urbanization levels, middle-income (and even some lower income) countries have already reached the point that today's rich countries attained only once they had crossed the high-income threshold. But, in the meantime high-income countries have moved on. In consequence, catching up today requires even more capital, education, innovation, infrastructure, as well as closer public–private collaboration, than was the case in the past.

Studying the history of industrial policy across countries and over the years, the most important lessons are not so much about the relative merits of individual policy tools and instruments. While details vary across countries and times, depending on the development context, these remain familiar. Some tools that were used widely by governments in the past are currently less accessible or no longer available because they are circumscribed or entirely ruled out by trade and investment agreements of various kinds (UNCTAD, 2014); or because of economic changes, such as financialization and the growing concentration of market power, that make them less effective. However, in one way or another, tariffs, subsidies, public procurement, state-ownership and regulatory measures will, with varying degrees of emphasis, continue to figure in the toolkit of policymakers seeking to diversify and upgrade the structure of their economies.

One noticeable change over the past two decades, with a direct bearing on the design and use of industrial policy, is the rapid expansion of global value chains in some key industrial sectors. Individual as well as clusters of firms based on developing countries has become engaged in these chains although the process has been far more prevalent in East and South-East Asia than in other developing regions. Participations in these chains have created the opportunity to produce and export manufactured goods, albeit more generally of low value added, and tightly controlled by leading multinational corporations.

This has been interpreted by some as a major paradigm shift away from traditional industrialization strategies and the policies these implied. Typically, participation in these chains involves high import content to comply with production specifications determined by the leading MNCs to meet minimum quality standards and ensure export competitiveness. The high import content requirements in turn imply an industrial policy based around government efforts to reduce the costs of transacting within these chains and tailored measures to attract FDI to specific links in the chain (Milberg and Winkler, 2013). However, simply complying with the demands of lead firms in these chains is unlikely to facilitate the emergence of the kind of industrial base necessary for sustained growth and inclusive development. There is little evidence of technological and other spillovers from TNCs in the absence of effective government bargaining and policy measures, even when greenfield investments have involved a fuller range of industrial activities, and evidence of upgrading within value chains is equally elusive. Accordingly, a 'developmental state' still has a critical role to play especially in proposing a broader industrial development perspective and in addressing the limitations of the value chain framework, particularly regarding the inability of developing countries to achieve significant upgrade within such chains.

In this context, a useful distinction among industrial policies is between 'passive' and 'active'. A 'passive' form of industrial policy essentially accepts the endowment and institutional structures and aims to reduce the costs of doing business, including coordination and transaction costs. By contrast 'active' industrial policy targets deeper changes in corporate structure and behaviour, including investment, exports, upgrading. As noted in the previous section, effective targeting of active measures requires dedicated monitoring and sanctioning capacity by the state, a degree of discipline that is often neglected in discussions of industrial policy.

The spread of global value chains does not change the basic industrial policy challenge. The need for a vibrant industrial base, robust local markets and a dynamic enterprise sector are, if anything even more important, if participation in these chains is to contribute to a continuous process of economic and technological upgrading. Accordingly, an active and comprehensive industrial policy framework will continue to employ subsidies and regulations to support domestic productive capacity, state-owned financial institutions to mobilize and allocate savings to support long-term investment priorities, secure profitability, socialize risks and facilitate the internalization of new technologies. It will also use public-sector procurement policies (such as tendering and reverse auctions) to support strategic sectors and the use of public investment to promote R&D and remove bottlenecks, especially in infrastructure and basic industries. Such policy will also develop competition rules and targeted policies to restrict market power, manage entry into key growth sectors, address coordination failures and regulate the ownership of productive assets, including intellectual property, to support investment and innovation and maximize learning spillovers. Finally, it will target measures to address regional inequalities, including tax incentives and support for appropriately qualified labour force through training and education programmes. The challenge, particularly given the constraints on more top-down policy mechanisms, will be to find the requisite mixture of both effective public agencies to bargain with more footloose businesses and more decentralized state institutions able to use an expanded range of support measures and instruments to build the clusters and linkages needed for an effective strategy of industrial diversification (Crespi *et al.*, 2014).

The selection of the relevant sectors and industries for industrial policy support varies from country to country according to their pre-existing areas of strengths and potential for upgrading, dynamic comparative advantage and, in the larger economies, creation of national champions that can become major players in the international markets. In South America, Brazil, a country with an already large industrial base, prioritizes sectors such as capital goods, electronics and pharmaceuticals, while Uruguay, a small country in the same region, is promoting biotechnology, ICTs and cultural industries, but also the automotive industry within a broader framework of regional productive integration, in recognition of the limitations imposed by its small domestic market.

These new industrial policies are evolving over time, embodying some but not all characteristics of successful development strategies of the past, showing the ability to adapt both to international changes and to local conditions and circumstances. Trade and investment agreements at the bilateral, regional and multilateral levels have restricted policy space in some key areas (UNCTAD, 2014) while the slowdown in developed countries, and the possibility that they have entered a period of secular stagnation, is constraining export possibilities to these economies. Accordingly, developing countries must design their industrial policies in this more constrained environment and respond to it through the adoption of innovative policies—or policy tools less subject to restrictions by international agreements—and by exploring new pathways for industrial development. However, it is important that they still have sufficient policy space to pursue development strategies that are conducive to sustainable development (Rodrik, 2004).

Given the new constraints in the external environment, south–south cooperation (SSC) is opening up new opportunities to bolster regional trade and productive integration in support of structural transformation. The East Asian experience has been a notable example of successful regional integration supporting rapid productive transformation (UNCTAD, 1996, 2007). Other developing regions have established a large number of sub-regional trade agreements, but progress on the ground in the form of substantially larger intra-region trade flows and productive integration has been limited, due to insufficient support for productive capacity building, lack of trade-related services (e.g. insurance and trade finance), poor physical infrastructure, economic volatility and lack of policy

coordination. Despite these obstacles, the south has demonstrated a renewed interest in regional trade agreements, given the lack of dynamism of the world economy and the difficulties this is creating for a continued expansion of world trade. SSC can bolster regional trade integration initiatives by helping overcome the obstacles that have hindered their development to date. It can also set up new financing mechanisms for trade and infrastructure development, and most of all it can support a more ambitious development agenda that focuses on productive capacity building and structural transformation at the regional level.

While SSC can help support a development strategy that is less dependent on the north, the developed economies are likely to continue generating crises that affect developing countries and their ability to maintain sustainable growth. This is due to the fact that the various financial, trade and other links between the north and the south continue to remain important despite the recent growth record in the south. At the same time, the recent global financial crisis made it evident once again that there is insufficient international provision of international liquidity and suitable multilateral mechanisms to help developing countries cope satisfactorily with trade and financial shocks. The attempts to reform the current architecture in the wake of the global crisis have been largely inadequate and slow (UNCTAD, 2015).

In the face of these deficiencies and failures to address them in the aftermath of the global financial crisis, SSC can play a crucial role to fill the gaps in the international financial architecture in critical areas for developing countries, such as macroeconomic volatility and external shocks in particular, which hinder their prospects of sustainable growth and development (UNCTAD, 2007; Grabel, 2011). But in addition to short-term financing to deal with financial and other shocks and monetary mechanisms to support regional trade integration, developing countries embarking on a strategy of rapid and transformative development would do well to revisit the role of development banks that can provide long-term finance. The recent creation of a BRICS bank and the Asia Infrastructure Investment Bank represents an important step to help meet these financing challenges.

While a 'vent for surplus' through a strong investment–export nexus will remain a feature of development strategy for most developing countries, the combination of a slow and fragile economic recovery in the developed economies has already taken its toll on global trade and dented expectations of an export-led catch-up story. Indeed, with serious debt and overcapacity issues at play, paying greater attention to expanding domestic markets will be key to meeting a more ambitious development agenda. A growth strategy that gives greater emphasis to domestic demand must start from the recognition that, even in relatively poor countries and in countries with a relatively large export sector, labour income is the major source of domestic demand. Therefore, policies aimed at increasing the purchasing power of the population overall, and wage earners in particular, need to be an ingredient of a strategy that favours promoting domestic relative to external sources of growth.

Measures aimed at a more equal distribution of income through setting a minimum wage, direct taxation and welfare-enhancing programmes will be central to such a strategy. These measures, which will effectively lead to wage increases closer to average productivity gains, play a dual role: they help sustain aggregate demand and will trigger improvements in productivity through demand-driven technical progress. Greater public-sector employment along with active labour market policies aimed at both formal skills development as well as on the job training will also be key to the success of any such strategy.

## Conclusion

This article discusses some of the key building blocks of a new development strategy for developing economies. It focuses on active industrial policy, on potential south–south-based mechanisms that can sustain this policy effort, mitigate deficiencies in the current international economic system and ultimately facilitate strategic insertion

of the south in the global economy, and on measures to boost domestic demand. What seems abundantly clear from an examination of success stories of the past is that trade, investment and industrial policy challenges should be approached in an integrated fashion as part of a broader development vision of progressive structural changes and rising living standards. This requires the presence of institutions that can fashion a vision of the national interest that is not limited to those with privileges and vested positions in the status quo. Political leadership and effective governance structures to build and sustain support for inclusive development paths are therefore, consequently, crucial ingredients for the prospects of their success.

## Notes

1 The World Bank (2012) estimates that out of the 101 countries classified as middle-income in 1960, only 13 had graduated to high income in the five decades that followed: Equatorial Guinea, Greece, Hong Kong SAR (China), Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, the Republic of Korea, Singapore, Spain and Taiwan (China).

2 For further discussion, see Arias and Wen (2015), Doner and Schneider (2015), Kahras and Harinder (2011), Felipe (2012a, b), Jankowska *et al.* (2012), Fortunato and Razo (2014).

3 See also Bairoch and Kozul-Wright (1996). Such a role was also forged in some smaller economies on the European periphery beginning in the interwar period, such as Finland and Austria, and, later, Ireland, see Katzenstein (1985), Vartiainen (1995), O'Riain (2004).

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