

Escaping the Middle Income Trap: The Role of International Trade

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Abstract:

Since the introduction of the concept a decade ago, the Middle Income Trap (MIT) has received enormous attention from economists, development practitioners and international organizations, such as the United Nations, World Bank, and the IMF. The MIT describes the phenomena when countries entering the middle income bracket are unable to advance to high income status. Out of 101 middle income countries in 1960, only 13 were able to become high income by the year 2008. Even though a singular prescription for escaping the trap is yet to be established, some authors assume the trade patterns of countries to be key (Aiyar et al. 2013). Felipe et al. (2012) argued that higher product complexity and export diversification play an important role for avoiding the MIT, to which Eichengreen et al. (2013) add that a large share of high-tech exports may help to avoid a growth slowdown. Based on a study of the five East Asian countries which escaped from the MIT, Kanchoochar (2015) argues that export expansion alone is not sufficient for sustaining structural transformation but export composition is also important. Although, the available literature recognizes trade patterns as important for escaping the MIT, a comprehensive examination of the trade patterns of the 13 countries that escaped the MIT is still missing. Thus, *the current research seeks to respond to the question what has been the international trade patterns of the countries that escaped from the MIT*. In the analysis we focus on 12 of the 13 countries due to availability of data: Japan, Taiwan, Singapore, South Korea, Hong Kong, Greece, Ireland, Israel, Mauritius, Portugal, Puerto Rico, Spain, and Equatorial Guinea. In the empirical investigation, time series data on trade patterns covering the 1960-2008 years are analysed using trend analyses.

1. Introduction

Nowadays one of the world economic challenges is the extremely bad position of the developing countries. On one hand it cannot be accepted morally that the majority of the inhabitants in these countries live on less than 1 dollar a day. On the other hand, the disadvantaged situation of these economies has effect on the international community also: in the current era of globalization, mutual dependence, threatening international terrorism, global epidemic danger and global climate change we have to take account of the problems of the developing nations as emphasized in the 2030 Agenda for Sustainable Development popularly referred to as the Sustainable Development Goals or SDGs (UN, 2015,). Several international organizations try to decrease this problem, but the financial aid they grant has dangers (e.g. corruption, dependency) and it becomes not effective in the long-term view (Szent-Iványi 2005).

The most widely used indicator to distinguish countries based on income is the World Bank's classification which was introduced in 1987. This classification distinguishes between four income categories based on the real per capita gross national income (GNI) calculated on the basis of the Atlas method. According to the most recent World Bank (2018) calculations, middle income countries are those with GNI per capita between the range \$996 and \$12,055; the middle income bracket is further divided into the lower (\$996 and \$3,895) and upper middle (\$3,896 and \$12,055) income groups respectively. Countries within the low and middle income thresholds are classified as developing economies whereas the high income countries are considered as advanced (World Bank, 2018).

Among the developing countries, there is a special club that catches our attention: the countries that have remained in the middle income bracket for decades and they still have not been able to increase their income level and join a higher level group. These countries are considered being in the so-called middle-income trap (MIT). There are several studies investigating how to escape from the MIT but there is no real receipt. Since current economic trends appear in the era of globalization when openness is a key factor, in this study we are focusing on trade openness. Thus, *the current research seeks to respond to the question what has been the international trade patterns of the countries that escaped from the MIT*. We aim to conclude some recommendations and lessons based on the experiences of these countries. In the analysis we focus on 12 of the 13 countries due to availability of data: Japan, Taiwan, Singapore, South Korea, Hong Kong, Greece,

Ireland, Israel, Mauritius, Portugal, Puerto Rico, Spain, and Equatorial Guinea. In the empirical investigation, time series data on trade patterns covering the 1960-2008 years will be analysed using descriptive statistics to determine whether the composition of trade for the countries have changed over time.

The first part of the study shortly overviews the literature on the relations between participating in international trade and economic growth. Then we give an insight to the middle-income trap phenomenon. In the second half of the paper we give a simple statistical analysis on the countries that escaped from the MIT.

2. The role of trade in economic development

Previously it was said that trade is an engine of growth (Ekholm & Södersten 2002, Freund & Bolaky 2008), but nowadays it is accepted that trade can contribute to economic development and poverty reduction (Dollar & Kraay 2003, Hallaert & Munro 2009, UNCTAD 2005). Recently “*Trade not aid – Aid not trade*” approach is accepted to help developing countries solve their unfavorable economic (and social) situation. The financial crisis of 2008 also raised the attention to the fact that besides aid, a more effective and sustainable solution is needed to promote economic development, and one of the possible tools can be the promotion of their participation in international trade. Although several trade preferences (preferential market access and free trade agreements) were granted to underdeveloped countries, a number of these countries – especially the least-developed ones – are unable to take part in international trade effectively, and their share in world export is decreasing: the African countries perform the worst.

Besides the classical-neoclassical theories (Todaro & Smith 2009), the export-base theory (dealing with regional development) emphasizes the importance and advantages of international trade as a key point for further development (Lengyel-Rechnitzer 2004). This trade-focused approach can be seen in the practice of both the United Nations (UN) and the World Trade Organization (WTO). In 2000 the UN announced the Millennium Development Goals, one of which declares ‘Develop a global partnership for development’ (UN 2008), which contains trade promotion. Besides, the WTO launched the Aid for Trade development program aiming the establishment and development of trading capacities (such as infrastructure) in the developing countries, so they could take part in the international trade more effectively (OECD-WTO 2007).

Although the impacts of export promotion and trade openness on the macroeconomic performance are not clear (see, for instance, Hoekman and Özden (2005), Lee (2005) or Subasat (2002)), the international community has been paying great attention to the role of international trade in economic development and poverty eradication. Some researchers claim that export promotion can be successful in middle-income countries (Dodaro 1991, Subasat 2002, Yaghmaian 1994). Furthermore, trade openness may contribute to increase the value added in industry, so it may affect economic development (Dodzin & Vamvakidis 2004). That is why it is assumable that participating in international trade may also contribute to escape from the Middle Income Trap.

3. The Middle-Income Trap

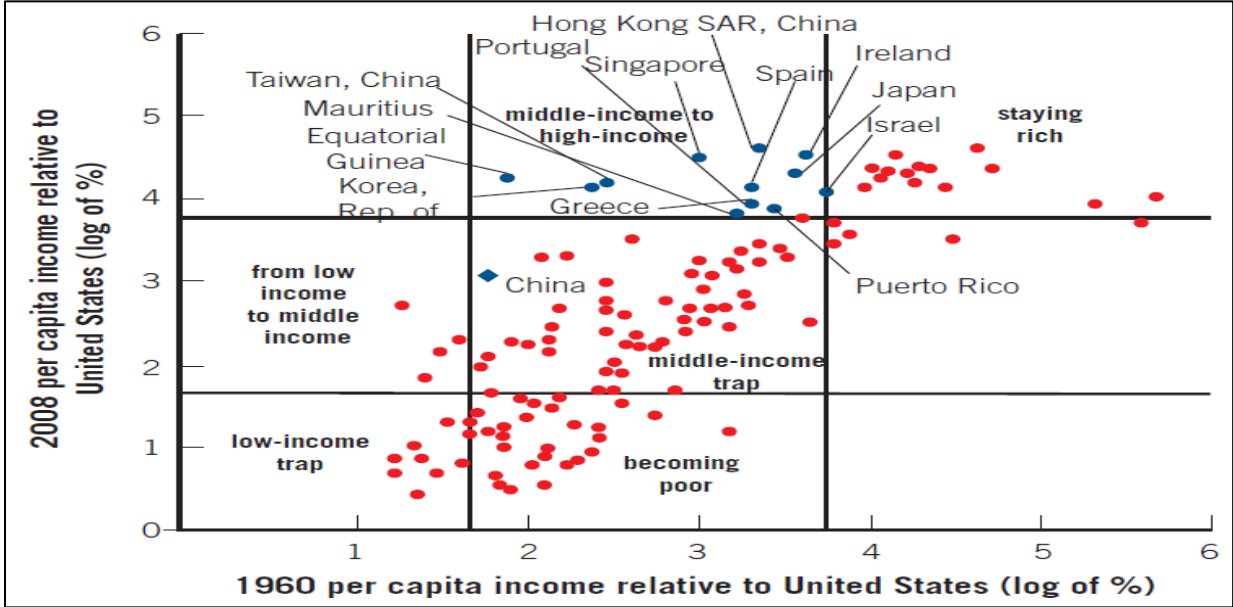
3.1 Main concept of the Middle-income trap

According to Gill and Kharas who introduce the term ‘middle income trap’ (MIT) in a 2007 World Bank Report titled ‘*An East Asian Renaissance, Ideas for Economic Growth*’, the MIT concept emerged due to the inability of the existing economic growth theories to inform development policy satisfactorily in middle income countries (Gill & Kharas, 2015). Until the emergence of the concept of the MIT, the endogenous growth theories and the Solow growth model had been the foremost economic frameworks put forth to explain the differences in economic performance of nations. However, Gill and Kharas (2015) posit that, although the endogenous growth theories and the Solow growth model were successful in addressing growth problems in high income and low income countries respectively, neither of those two frameworks were satisfactory in understanding and addressing the nature of economic growth challenges in middle-income countries. This gave rise to the notion of MIT which Glawe and Wagner (2016) have observed is relatively new phenomenon, conceptually.

Different definitions of the the MIT have been proposed; however, the term is generally used to describe countries that experienced rapid growth, which enabled them to reach middle-income status but are not been able to catch up to the developed countries and achieve high-income status; but rather, they get caught in the middle-income range – the so-called MIT (Gill & Kharas, 2015; Glawe & Wagner, 2016; Zhou et al. 2018). According to Glawe and Wagner (2016) there are two groups of definitions for the MIT. These are “(primarily) theoretical definitions” which define the MIT in terms of the structure and characteristics of an economy and the “(primarily)

empirical/quantitative definitions” which are based on growth rates, and gross national income of countries. With the advent of the of the Fourth Industrial Revolution, Glawe and Wagner (2018) have created a new concept: Middle Income Trap 2.0 which they posit will be more difficult to break out than the normal MIT. Out of 101 middle income countries in the year 1960, only 13 were able to advance to high income status (see figure 1).

Figure 1: World Bank Estimate of 13 Countries that escaped Middle Income Trap

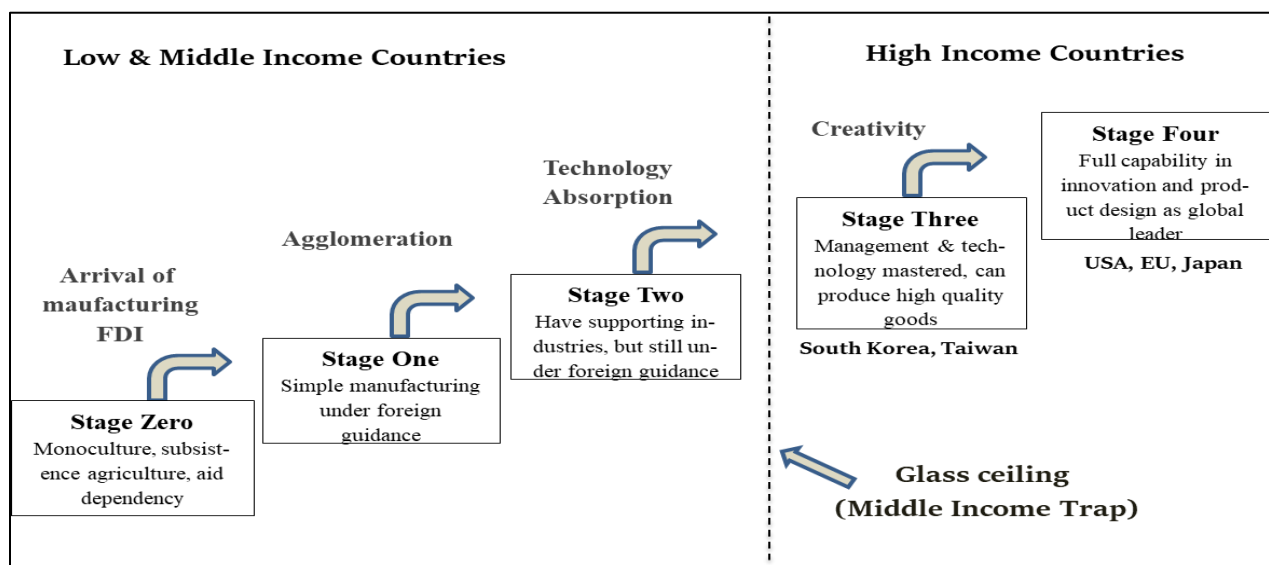


Source: World Bank (2012)

It should be noted that the estimate of the 13 countries that escape the MIT was based on a relative definition of MIT which compares the per capita income of countries to that of the United States. Currently, there is no single cause or solution for overcoming the MIT in literature; several authors have expoused different ideas. For instance, Eichengreen et al. (2013) based on empirical studies have observed that growth slowdowns associated with the MIT occur less frequently in economies where a relatively large share of the population have higher secondary and tertiary education. Therefore these authors share the views of Jimenez et al. (2012) and Jitsuchon (2012) among several authors who posit that investments in human capital is the key for escaping the MIT. In a recent study, Glawe and Wagner (2018) points out that improving human capital accumulation, particularly the upgrading of skills needed with the rapid advance of automation as result of the Fourth Industrial Revolution, will be key success factors for overcoming the MIT 2.0.

Some of the earliest authors on the concept of MIT such as Garrett (2004); Gill and Kharas (2007); Ohno (2009); as well as Kharas and Kohli (2011) who proposed theoretical definitions, define the MIT as a form of political failure characterised missing structural and institutional reforms (Glawe & Wagner, 2016; World Bank, 2012). Using models such as the Dual-sector model developed by W. Arthur Lewis also known as the Lewis model, and Rostow’s Stages of Economic Growth model, this group of authors argues that factors that generate growth in low-income countries are no longer available once an economy achieves middle income; therefore, countries fall into the MIT if they are unable to transform their economies from subsistence to modern economies. An example of this perspective is the Middle Income Trap Model proposed by Ohno (2009) as depicted in Figure 2 in which countries that are stuck in the MIT are characterised by aid dependency, subsistence agriculture, and simple manufacturing. Based on this model, the process of escaping or breaking out of the MIT is described as a catch-up process in which development is viewed as a linear process in which the successful transition from one stage to another depends on how well a country is able to fulfill the corresponding requirements that vary from one stage to the next (Glawe & Wagner, 2016).

Figure 2. Stages of the catching up in Ohno’s Middle Income Trap Model



Source: Authors construct adapted from Glawe & Wagner (2016).

3.2. Escaping from MIT – the role of international trade

The role of international trade in escaping the MIT takes its roots from the theoretical definitions of the MIT. From this perspective, it is argued that structural change and trade/imitation are the two main growth drivers of developing countries; therefore, if these initial growth drivers become exhausted, countries may become stuck in an MIT if they are unable to quickly shift to an innovation-based growth strategy (Glawe & Wagner, 2016, 2018). What is of interest in this paper is the trade/imitation argument which according to Glawe and Wagner (2016) originates from (neo)classical trade literature and the leader–follower models proposed by authors such as Barro and Sala-i-Martin (1997). The trade/imitation argument focuses on the imitation of foreign technologies and comparative advantage as the main drivers of growth. The core tenet of this perspective is that an economy in its early phase of development can generate (transitory) growth if it specializes in labor-intensive and low-wage tasks/goods (according to its comparative advantage), and succeeds in imitating the technology of more advanced countries as the country grows (Glawe & Wagner, 2016).

In order to cope with challenges such as automation becoming less costly as a result of the 4th Industrial Revolution and avoid the MIT 2.0, Glawe and Wagner (2018) posit that developing countries need to diversify their export baskets and move up the value chain so that they can compete with advanced countries. It has been observed that poor developing countries usually have a small basket of products and the exported products are of low-complexity (Zhou et al., 2018). It is based on this premise that the theoretical definitions of the MIT argue that political and institutional adjustments such as shifting from an export-manufacturing based growth model to an innovation-technological based growth model are necessary when a country enters the middle-income range to avoid the MIT. Zhou et al. (2018) points out that a disputed issue arises: whether the country should shift its attention from low-complexity to high-complexity products. Whereas classical economists such as Ricardo emphasize the importance of specialization on few high-complexity products, recent research based on the complex network model shows that developed countries tend to diversify their export basket to improve their competitiveness, meaning that competitive countries have better industrial structure on both high- and low-complexity products (Zhou et al., 2018).

Some empirical studies have sought to investigate the relationship between international trade and the middle income trap. For instance, Reyes et al. (2007) have used Complex Network

Analysis to assess the evolution of International Economic Integration in East Asia and Latin America and how that has contributed to their development status using COMTRADE database and bilateral trade data for 171 countries over the 1980–2005. This methodology allowed the authors to investigate the whole structure of international trade relationships and to determine both the position of High Performing Asian Economies (HPAE) and Latin American Economies (LATAM) in the network and its evolution over time. Reyes et al. (2007) found that HPAE countries are more integrated into the world economy, as they have moved – over the past 25 years – from the periphery of the network towards its core. In contrast, the LATAM region seems to be losing presence within the network or, at best, its integration process has remained stagnant possibly explaining why many of them remained in the middle income range for a long period of time. The authors conclude that it is not only the degree of openness that matters for the economic performance of countries, but also their positioning within the network of international trade flows since there seems to be a core-periphery set up in the scheme of global trade.

Using the Fitness-Complexity method (FCM) to analyze the common characteristics of the countries that successfully get through the middle-income trap, Zhou et al. (2018) illustrates the origin of the middle-income trap based on the international trade network. Their analysis reveals that developed countries export more low-complexity products than developing countries, indicating that, when a developing country gets through the middle-income trap, it should develop low-complexity products as well as high-complexity products. Felipe et al. (2012) also focus on the export composition argument suggesting that higher product complexity and export diversification play an important role for avoiding the MIT. Similarly, Eichengreen et al. (2013) have observed that a large share of high-tech exports, may help help countries to avoid growth slowdowns associated with the middle income trap. Based on a study of the five East Asian countries which escaped from the MIT, Kanchoochat (2015) argues that export expansion alone is not sufficient for sustaining structural transformation but export composition is also important. These assumptions resonates with the Nairobi Maafikiano (TD/519/Add.2, paragraph 57) which emphasizes the importance of economic diversification into modern, sustainable and more technologically advanced productive activities, as well as the production of higher value products (UNCTAD, 2018). According to UNCTAD (2018) this transformation is considered essential for sustainable long-term growth and for building resilience to the shocks that periodically affect the economic performance of developing countries and countries with economies in transition. In

spite of these theoretical assumptions and prepositions, what is still missing in the MIT literature is a comprehensive analysis of how the trade structure of the countries that escaped the MIT from 1960 to 2008 has evolved over time.

4. Trade patterns of countries escaped from MIT

4.1. Data and methodology

The study uses official secondary data obtained from UNCTADStat database. The study utilizes descriptive statistics and trend analysis to examine how the trade structure of the countries that escaped the MIT from 1960 to 2008 have evolved overtime in order to determine whether composition of trade: high and lower value added products changed over time as suggested by literature. Specifically, the study analyses the following components of exports and how they have evolved overtime: Primary products, Low technology manufactures (textile, garment and footwear), and High technology manufactures (electronic and electrical). The results of the various analysis are discussed in the next section.

4.2. Results

A descriptive analysis of the export data for 12 countries that escaped the MIT from 1960 to 2008 indicates that, each of the countries recorded an annual increase of total exports by at least 10 percent per annum. In terms of volume of trade, Japan (\$232,776.54 million) recorded the highest average exports over the period followed by Hong Kong and South Korea (See Table 1). However, in terms of percentage growth in exports over the period, South Korea recorded the highest annual increase in export growth (23%) followed by Equatorial Guinea (20%) and Taiwan (18%). The findings suggests that the annual increase in total exports over the period 1960 to 2008 may have played a major role in what is described in Economics and Development literature as the East Asian Miracle since the 5 East Asian countries which escaped the MIT also recorded the highest average exports out of the 12 countries analysed (See Table 1).

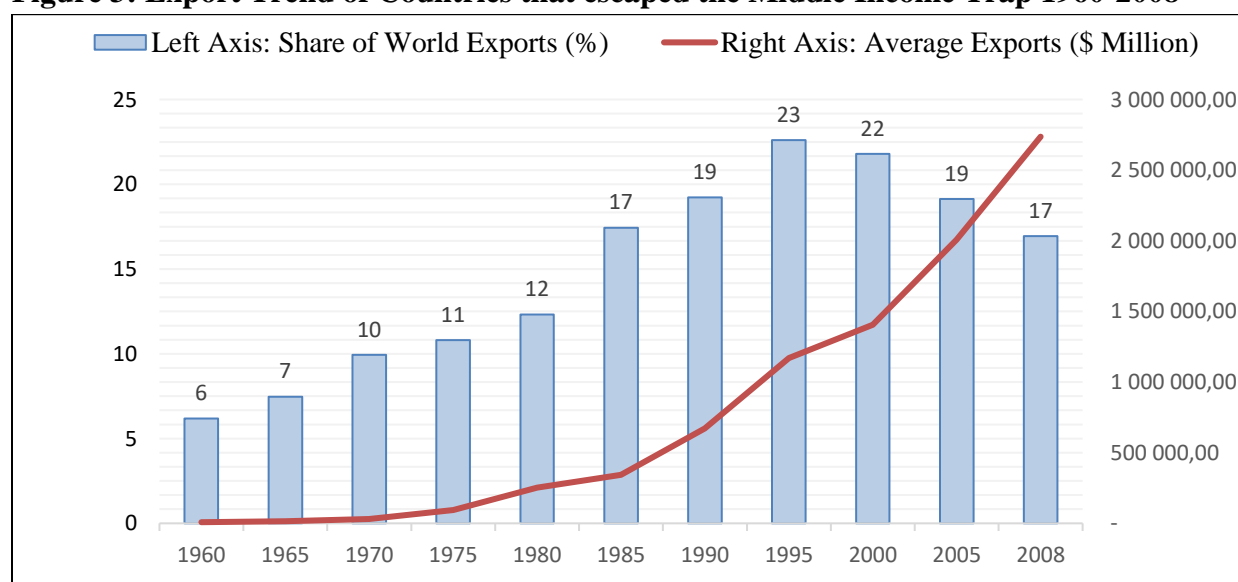
Table 1: Average Annual Export Growth of countries that escaped the MIT 1960-2008

Country	Average Yearly Exports (USD at current prices in millions)	Average Annual Export Growth (%)
Japan	232,776.54	12.14
Hong Kong	88,827.25	14.53
South Korea	77,723.59	23.21
Singapore	64,428.65	13.76
Taiwan	63,460.57	17.55
Spain	58,045.45	13.83
Ireland	30,460.69	12.99
Israel	13,090.19	12.81
Portugal	12,886.18	12.10
Greece	6,679.85	11.66
Equa. Guinea	1,144.67	20.46
Mauritius	841.90	11.02

Source: Authors calculations based on UNCTADStats Export data 1948-2018.

*Puerto Rico was among the 13 countries that escaped the MIT but are omitted from this analysis due to unavailability of data.

A trend analysis of the international trade data for the study countries indicates that their exports grew exponentially between 1960 to 2018 (See Figure 3) while their share of world exports also increased over the period from 6 percent in 1960 to as high as 23 percent in the year 1995. The countries that escaped the MIT alone consistently have contributed to not less than 17 percent of total world exports since 1985.

Figure 3: Export Trend of Countries that escaped the Middle Income Trap 1960-2008

Source: Authors construct based on UNCTADstats data.

Based on the assumptions in literature that trade composition plays a major role in economic development and escaping the middle income trap, this paper analysed the evolution of the composition of exports of 12 of the 13 countries that escaped the MIT from 1960 to 2008. Due to the availability of data, the analysis starts covers the period 1995 to 2018.

A descriptive analysis of the components of the export data for the countries analysed indicates that, on average, high technology exports contributed the highest percentage of the exports of the majority (9) of the countries studied. With the exception of Equatorial Guinea which had its exports primarily composed of primary products as well as Greece and Spain which both had primary products and low technology products contributing higher percentages of the exports as compared to high technology products, all the other 9 countries had high technology exports contributing the highest percentage followed by low technology manufacture and the primary products.

Table 2: Average Export Composition of Countries that Escaped the MIT 1995-2018 (%)

Country	Primary	Low Technology	High Technology
Equatorial Guinea	84.1	0.0	0.0
Greece	20.4	12.0	3.0
Hong Kong	2.4	16.4	38.6
Ireland	4.6	0.9	19.2
Israel	3.3	2.6	14.5
Japan	1.7	1.0	19.1
Mauritius	5.7	46.4	3.4
Portugal	5.1	18.6	5.1
Singapore	2.0	1.1	40.7
South Korea	2.4	5.4	27.3
Spain	12.1	6.3	5.2
Taiwan	2.9	6.3	37.7

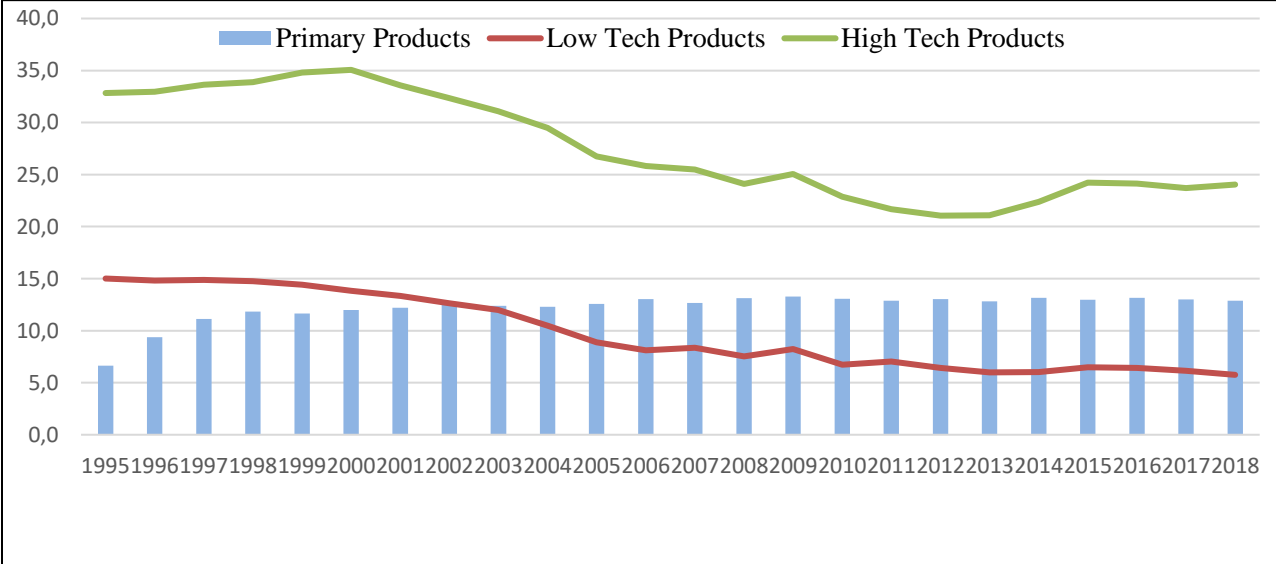
Source: Authors calculations based UNCTADstats database.

All the countries analysed had less than 10% of their exports being composed of primary products over the study period with the exception of Equatorial Guinea, Spain, and Greece (See Table 2). Equatorial Guinea is the only country that was able to escape the middle income trap by relying primarily on primary products – the main reason for that is that Equatorial Guinea is one of the largest oil producers in Africa, so the changes in oil prices might largely influenced that the county become rich. Equatorial Guinea was classified as a high income country in 2007 at a time when

their primary products (oil) contributed to about 95% of the country’s exports. However, the country was recategorized as a middle income country in 2015 at which time the primary products component of the country’s exports began to decline. The case of Equatorial Guinea suggests that growth based on primary products is unsustainable. This finding is consistent with literature and the position of UNCTAD (2018) that economic diversification into modern, sustainable and more technologically advanced productive activities, as well as the production of higher value products is essential for sustainable long-term growth and for building resilience to the shocks that periodically affect the economic performance of developing countries and countries with economies in transition. Thus the need for countries to identify and exploit new growth drivers.

A trend analysis of the trade structure of the countries that escaped the MIT indicates that, on average high technology products constituted the highest percentage of exports of the countries studied followed by low technology products and then primary products in that order until the year 2003 when primary products overtook low technology exports (See Figure 4).

Figure 4: Export Composition of Countries that escaped the MIT from 1960-2008 (%)



Source: Authors construct based UNCTADstats data.

The study also found that all the other countries studied experienced a reduction in the low technology products composition of exports although there are variations in the trends of different countries. Again, out of the countries analysed, Mauritius, and Taiwan are the only countries that higher average high technology exports than the initial value at the beginning of the study period.

5. Conclusions

Generally, the countries that escaped the MIT had higher proportions of their exports being from high technology products. This is consistent with literature and the MIT hypothesis on the role of international trade in escaping the trap and therefore suggests that the international trade structure of countries is an important determinant of the middle income trap. The case of Equatorial Guinea suggests that economic growth based on primary commodities is unsustainable. This is also consistent with MIT literature that suggests that total factor productivity growth is more sustainable and relevant for avoiding and escaping the MIT. A limitation of this study is that it only focuses on how the trade structures of the countries that escaped the MIT evolved over time; it does not examine the impact of trade on the GNI per capita which is the indicator used by the World Bank to classify countries into different income brackets. Further studies should examine the determinants of the export composition and trade structure of the respective countries as well as the mechanisms of international trade in avoiding and escaping the middle income trap.

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