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Global Shifts in Manufacturing and Services

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Description of Change

The world economy is experiencing two structural shifts. The first is a demand-driven shift in the rich (OECD) countries from manufacturing to services. The second is a supply-led shift of manufacturing production from rich countries to middle-income developing countries. These sectoral and geographic shifts reinforce each other, accelerating the loss of manufacturing jobs in the OECD countries.

The effect on employment will be similar to the shift from agriculture in this century. In 1900 farming employed 68 percent of the labor force in Japan, 44 percent in the United States, and 19 percent in Britain. Despite heavy protection of the sector in all three countries, job loss was universal. By 1990 the shares were 7 percent in Japan, 3 percent in the United States, and 2 percent in Britain.

Manufacturing employment is likely to show the same trend. Labor-saving technology will increase output. Because manufactured goods are highly tradable, incremental production capacity can migrate to low-cost locations. Thus, both account for a shrinking share of consumer spending as incomes rise. Thus we may expect to see:

1. Manufacturing employment continuing to fall in the OECD countries, reaching 10 percent or below in most in 30 years.
2. Faster job loss in those countries where manufacturing employment is currently the highest: Germany (currently 32 percent), Japan (24 percent), and Italy (22 percent). The biggest falls so far have followed this pattern. They have been in Germany and the United Kingdom, which were the two most industrialized countries at their peaks.[1]

[1] The rationale for these predictions is contained in Brown and Julius, "Is Manufacturing Still Special in the New World Order?" In R. O'Brien (ed.), *Finance and the International Economy.* New York: Oxford University Press, 1993, on which this article is based.

Reasons for Change

Over the long sweep of economic history, such shifts are more the norm than the exception. Examples of other geographic and sectoral shifts include the European emigration to the Americas, the industrial revolution, the abolition of slavery, and the decline of domestic service. It would be surprising indeed if the current period of unprecedented technological and political change did not produce something similar.

On the political front, the major catalyst has been the sudden collapse of the Soviet Union. That shook the last vestiges of belief in the centrally planned, closed economy model. As a result, radical policy change is underway, not only in Eastern Europe, but also in such diverse places as South Africa's ANC, Argentina's Perónist party, China's Communist party, and India's socialists. Not all of these can be traced to the end of the Cold War—some began long before 1989—but the spread of radical, market-oriented policy reform in the developing world is undeniable.

Less noticeable, but equally important, has been the slow but steady improvement in the skill base of developing countries. This means that the seeds of policy reform are falling on well-prepared soil. Between 1965 and 1988 secondary school enrollment leapt from 26 percent to 55 percent of the school-age population in the 58 middle-income developing countries. The skills gap is closing and productivity is rising.

Probable Consequences

This is pulling investment toward developing countries—both international direct investment (IDI) and portfolio investment via the many emerging market funds. In just 5 years, the share of IDI captured by the developing world jumped from 17 percent to 33 percent of the total. This is both cause and effect of the growing expectation that economic growth in the LDCs is likely to be in the 5 to 6 percent range over the next decade, compared with under 3 percent during the 1980s.

As this growth swells, the number of middle-income families in Asia and Latin America, their consumption of everything from color televisions to motorcycles to computers to cars will grow much faster than in the mature markets of the OECD countries. To meet that demand, companies that manufacture such goods will naturally build new plants there, where costs are lower and markets are booming. This will cause the center of gravity of global production of manufactured goods to shift from today's rich to today's poor countries.

Does this matter? In the paper cited earlier, the arguments are spelled out in some detail. The bottom line is that the loss of manufacturing jobs does not matter—and indeed is a healthy and welcome shift—as long as service sector jobs continue to grow and the OECD's service companies are able to compete internationally.

The first requirement poses little concern. In nearly every OECD country, job growth in services has been significantly faster than in any other part of the economy for a very long time already. It was services, not manufacturing, that absorbed the massive shift of labor out of agriculture after World War II.

The main force behind this job growth has come from the demand side. Across the OECD, the demand for services is growing faster than the demand for goods. Even for traditionally up-market goods such as VCRs and home computers, sales in recent years have grown more slowly than GDP, despite price declines. The sectors that are growing faster than GDP now are telecommunications, business services (design, advertising), health care, travel, and entertainment. There are also some supply-side drivers. Women are the fastest growing component of the labor market, and they have revealed a preference for service sector jobs. Such jobs are often more flexible and provide higher levels of worker satisfaction.[1]

The key question is who will supply the growing demand for services. This is where the importance of international competition and trade becomes critical. Traditionally, most service companies were restricted to their home market and, as a quid pro quo, were protected from international competition on their home turf. That was true of telecommunications, insurance, gas, electricity, and airlines. This cozy arrangement had the unwelcome effect of limiting both industry size and productivity growth. Economies of scale could not be sought beyond the home market and competitive pressures there were not sufficient to drive technological or managerial change. An erroneous belief was born that services were inherently less capable of productivity growth than manufacturing and thus could provide only low-wage jobs. The key to changing this is to unleash real competition and trade in services.

Proposed Actions

Effective market access is the essential basis for world trade in services, just as tariff reduction was the key to liberalizing trade in goods. Unlike goods, many services can only be produced where the consumer is. Unless foreign service firms have access to those consumers, trade in services cannot take place.

[1] Gallie, Duncan, and White, *Employment in Britain.* BEBC Distribution, June 1993.

The restriction of such access is still common in OECD and developing countries. Ask the insurance company that has to get clearance from 50 state regulators in the United States to do business. Ask the construction company bidding for a contract in Japan. Ask the airline trying to fly domestic routes in almost any foreign country. Most of the world's largest service companies still have no effective competition in their home markets.

The new Uruguay Round agreements contain a framework for trade in services and a much enhanced dispute settlement process. We must now build on that to negotiate effective market access across a wide range of service industries with their diverse regulatory barriers. Because of their diversity, this will have to be done sector by sector. And because access is often via direct investment, rather than trade, the new World Trade Organization (WTO) will have to expand its remit.

Multinational companies can contribute to this in two ways. First, they could become involved in the sectoral negotiations. Both their experience of operating under different regulatory regimes and their own interest in opening markets will often be broader than those of any particular home or host government. The WTO would benefit from involving them directly in setting the negotiating agenda.

Second, the time has come to grant multinational companies direct access to the dispute settlement process in the WTO. As international corporate citizens, they require an impartial judicial forum where disputes with governments that relate to international commercial transactions (trade, investment, and intellectual property) can be heard and where a case of law of such judgments can be built to guide future action. The current patchwork of bilateral investment treaties and the confidential nature of arbitration proceedings provide an insufficient base for the major expansion of IDI that is needed to make services fully tradable.

This task will not be easy. But we should not underestimate the very severe pressures that our economies will face if we fail. A major shift in comparative advantage is underway. Our choice is a stark one. We can try to slow the job loss in manufacturing—as we watch wages decline—or we can enhance job creation and productivity in services. The key to that is effective market access and dispute settlement. Our task now is to build the WTO into the driver for this new growth dynamic.