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| The EconomistJune 28th 2011Patrick LanePatrick LaneThe moderator's opening remarksWelcome to the latest of *The Economist*'s online debates. Our topic for the next few days is one that has divided economic practitioners and commentators for as long as anyone can remember: how important is manufacturing? This old question has had a new lease of life since the financial crisis of 2007-08. To some, this is a cautionary tale of the celebration of finance and the neglect of manufacturing. Some economies that had seemingly come to rely on financial services, such as America's and Britain's, have struggled since. Meanwhile, Germany, a manufacturing power almost written off a few years ago, has performed strongly; and China, the world's workshop, has continued to clock up giddying growth rates. There is more to services than finance, of course; but those who believe that making things is the basis of economic prosperity may see in all this a degree of vindication.Others may say that the truth is more complicated. Japan, another place where prosperity has been built on making (and exporting) things, has stagnated for 20 years. And while China's boom has owed much to manufacturing, India has been enjoying a largely service-based surge. Look over a longer period than the few years since the financial bust, and you see that most rich economies have shifted the bulk of economic output (and to a greater degree, employment) away from manufacturing and towards services, and have done pretty nicely. Maybe manufacturing is not the be-all and end-all. And people on both sides, as well as neutrals, may wonder where manufacturing ends and services begin. Makers of many things, from aircraft engines to cars to telephone networks, will tell you that they do not simply make and sell fancy combinations of metal and plastic: customers want advice, design and maintenance too, as part of the deal. Manufacturing and services are complements not substitutes.The chief protagonists in our debate are distinguished economists: Ha-Joon Chang, of Cambridge University, who is proposing the motion, and Jagdish Bhagwati, of Columbia University, who is opposing it. Mr Chang starts by noting that even apparently service-based economies in fact have strong manufacturing foundations. Much of the shift away from manufacturing, he argues, reflects inherently faster productivity growth in that sector; some of the measured productivity growth in services, notably retailing, reflects lower quality and is thus more apparent than real. Deindustralisation and slow manufacturing productivity growth hurt a country's ability to export and eventually lead it into balance-of-payments difficulties. As for tradable services, they too depend in the long run on a strong manufacturing base.Mr Bhagwati, by contrast, believes that manufacturing has been fetishised by economists since Adam Smith. Technical progress is not confined to manufacturing: indeed, he says, there is evidence that retailing is the most progressive sector. Nor is it plain that progress in services depends on that in manufacturing in the same country. As for the financial crisis, he argues, in effect, that the baby should not be hurled out with the bathwater: though some financial "innovation" was destructive, some has surely done some good.This promises to be a lively debate. There are conceptual arguments to be played out. How, for example, is manufacturing defined? What constitutes a "base": having factories on home soil, or keeping hold of intellectual property? What difference does it make if supply chains are spread around the world? And in a debate with such a long history, there are surely plenty of data to be brought to bear too. These are not just questions for Mr Chang or Mr Bhagwati, or for the guest commentators who will contribute later. They are questions for you, too, the readers on the "floor" of our virtual debating chamber. I do hope that you will join in—and that you enjoy the debate. Ha-Joon  ChangHa-Joon Chang The proposer's opening remarksI propose that the state of a nation's manufacturing base (its size and competitiveness) is the most important determinant of its prosperity.Hearing this motion, some may ask: how about countries like Switzerland and Singapore, which have become rich through services, like finance, tourism and trading; don't they show the viability of service-based prosperity?Actually, they show the exact opposite. According to UNIDO data, in 2002, Switzerland had the highest per head manufacturing value added (MVA) in the world—24% more than that of Japan, the second highest. In 2005, it ranked second, after Japan. Singapore ranked third. So these supposed "model" service-based economies are in fact two of the strongest manufacturing nations in the world.Of course, there are some countries, such as Australia, that maintain high living standards without a big manufacturing sector, thanks to exceptional natural resource endowments. But most other countries are not so lucky. Without a substantial and productive manufacturing base, it is impossible for them to attain high living standards.There is truth in the argument that above a certain level of development, countries become "post-industrial", or "deindustrialised". But that is only in terms of employment—the falling proportion of the workforce in engaged in manufacturing. Even the richest economies have not really become post-industrial in terms of their production and consumption.From expenditure data in current (rather than constant) prices, it may appear that people in rich countries are consuming ever more services, but that is mainly because services are becoming ever more expensive in relative terms, thanks to structurally faster productivity growth in manufacturing.By their very nature, many service activities are inherently impervious to productivity increases. In some cases, the very increase in productivity will destroy the product itself. If a string quartet trots through a 27-minute piece in nine minutes, would you say that its productivity has trebled? For some other services, the apparently higher productivity may be due to the debasement of the product. A lot of the increases in retail service productivity in countries like America and Britain have been a result of lowering the quality of the retail service itself—fewer shop assistants, longer drives to the supermarket, lengthier waits for deliveries, etc.There are some service activities, such as finance, telecommunications and transport, which have had fast productivity growth in recent periods—sometimes even faster than those of some sub-sectors of manufacturing. However, these are mostly "producer" services, for which the main customers are manufacturing firms, so their growth is in large part dependent on the vitality of the manufacturing sector. Moreover, when it comes to financial services, the 2008 financial crisis has revealed that much of the recent productivity growth had been due to "financial innovations" that obscured (rather than genuinely reduced) the riskiness of financial assets, thereby allowing the financial sector to raise its productivity at an unsustainable rate. With the forthcoming tightening of financial regulation across the world, productivity growth in financial services will significantly slow down.But, one may ask, if de-industrialisation is due to the very dynamism of a country's manufacturing sector, isn't it a good thing?Not necessarily. The fact that de-industrialisation is mainly caused by the comparative dynamism of the manufacturing sector vis-à-vis the service sector does not tell us anything about how well it is doing compared with its counterparts in other countries. If a country's manufacturing sector has slower productivity growth than its counterparts abroad, it will become internationally uncompetitive, leading to balance-of-payments problems in the short run and falling standards of living in the long run. In other words, de-industrialisation may be accompanied by either economic success or economic failure.Even if it is of the "successful" variety, deindustrialisation is likely to have a negative effect on a country's balance of payments because services are inherently more difficult to export. At the root of the low "tradability" of services lies the fact that many require their providers and consumers to be in the same location. No one has yet invented ways to provide long-distance hairdressing or house cleaning. Of course, this problem will be solved if the service provider (the hairdresser or the cleaner in the above examples) can move to the customer's country, but that in most cases means immigration, which most countries restrict heavily.Given this, a rising share of services in the economy means that the country, other things being equal, will have lower export earnings. Unless the exports of manufactured goods rise disproportionately, the country will not be able to pay for the same amount of imports as before. If its de-industrialisation is of a negative kind accompanied by weakening international competitiveness, the balance-of-payments problem could be even more serious.To be sure, not all services are equally non-tradable. There are some high-value producer services that are highly tradable, such as banking, consulting and engineering. However, even in Britain, which is most advanced in the exports of these services, the trade surplus they generate is well below 4% of GDP, just enough to cover the country's manufacturing trade deficits. In the case of America, the surplus is less than 1% of GDP, nowhere near enough to make up for its manufacturing trade deficits, which are also around 4% of GDP. America has been able to maintain such a large manufacturing trade deficit only by borrowing heavily from abroad.Moreover, a country's ability to export many of these producer services cannot be maintained in the long run without a strong manufacturing sector. In services like engineering and design, insights gained from the production process are crucial. Given this, a weakening manufacturing base will eventually lead to a decline in the quality, and exportability, of these services.While a simplistic "manufacturing good, services bad" viewpoint is unwarranted, we undervalue the manufacturing sector at our peril. It has been at the foundation of human material, and social, progress at least since the Industrial Revolution and it is likely to remain so in the foreseeable future.  Jagdish BhagwatiJagdish BhagwatiThe opposition's opening remarksBill Emmott, a former editor of *The Economist*, is reputed to have remarked wittily about the "manufactures fetish" that most people think that unless one makes things that can be dropped on one's foot, they are not worth making. He would have been wittier if he had changed it to dropping them on one's foe's foot. As is often the case, this fetish has the highest pedigree: no less than Adam Smith himself. We know of course that Smith is often misunderstood, as when he is condemned by liberals (in the American, not the Manchester School, sense) as an unqualified proponent of laissez-faire, whereas he qualified his support for the division of labour by arguing that specialisation on the narrowest of tasks and endless repetition of them would turn workers into morons and that good governance supplying education to offset this was necessary. But, make no mistake, the founder of economics indeed dropped a brick, even a boulder, when he propounded the fallacy that I have called the manufactures fetish. In Book II of "The Wealth of Nations", he condemned as unproductive the labours of "churchmen, lawyers, physicians, men of letters of all kinds; players, buffoons, musicians, opera-singers, opera-dancers, etc." Perhaps, with Shakespeare, he may be right about lawyers; but surely not about Vanessa Redgrave, Monty Python, Salman Rushdie and Kiri Te Kanawa. But if Smith's error, which prompted the Soviets to omit services from their computation of GNP, is now relegated to the history books, the manufactures fetish continues to exercise a "fatal attraction" and resurrects itself periodically, but with different rationales. The most influential revival was by my Cambridge teacher, Lord Kaldor, who was one of the most eminent economists of his generation. He raised an alarm in the mid-1960s over British "deindustrialisation". He considered manufacturing to be more technically progressive and contrasted it with services, which he regarded as inefficient and technologically stagnant. I guess his view of services was formed by casual empiricism: stepping out of an Oxbridge college, one often saw small shops selling Cadbury's chocolates for a couple of shillings and then, turning the corner, one saw small, traditionally outfitted post offices. Lord Kaldor even managed to persuade the chancellor of the exchequer to impose a Selective Employment Tax in 1966—reversed in 1973—which taxed employment in services (with an amusing exemption for service at the High Table where dons like Lord Kaldor and me ate our sumptuous dinners). The problem was that Lord Kaldor had not registered the fact that modern services were technologically quite progressive. Indeed, the recent work of Dale Jorgenson of Harvard, the most prominent expert on measuring technical change, shows that retailing is the most progressive sector. (This is aside from the problem that, if the returns to better technology accrue to the firm, there is no reason to subsidise: one needs to establish an externality to advocate a subsidy. Besides, since Lord Kaldor believed that manufacturing output was the source of the alleged externality, the theory of optimal intervention also tells us that the appropriate subsidy would have to be related to output, not to labour.) The same fallacy was to resurface when a similar but within-manufacturing argument was made later in America that semiconductor chips should be favoured over potato chips as the manufacture of the former was considered technically advanced. But when a reporter visited a factory making Pringles, the potato chips that nest perfectly on one another in the little boxes in the mini-bars of upscale hotels—unlike the uneven ones that our grandmothers made—he found automated production, whereas semiconductors turned out to be manufactured in a mindless fitting onto circuit boards. Reality was the opposite of the rhetoric. The Kaldor worry about deindustrialisation resurfaced two decades later in 1987 when two political scientists from the University of California at Berkeley, Stephen Cohen and John Zysman, argued that "manufacturing matters" because, without it, other activities including services would be destroyed as they were in a tight complementarity production wise. They asserted that if you offshore "the tomato farm, you offshore or close the ketchup plant ... No two ways about it". I responded with sarcasm: "As I read the profound assertion about the tomato farm and the ketchup plant, I was eating my favourite Crabtree & Evelyn vintage marmalade. It had not occurred to me that England grew its own oranges." But if Lord Kaldor did not succeed for long in Britain, and Cohen and Zysman did not even get off to a start in America, the most recent return of the manufactures fetish, most notably in America but also in a milder version in Britain, may turn out to be more potent. The push for manufacturing has come in the aftermath of a devastating financial crisis, which exposed the asymmetry between financial and non-financial innovation. The latter poses problems of what Schumpeter called "creative destruction": ie, how to prevent Luddite reactions. But financial innovation leads to the possibility of what I have called "destructive creation": ie, a huge disruption of the financial system as we have just experienced. The phrase "innovation" lulls us into the false equation of financial and non-financial innovation. Of course, Paul Volcker's remark that the only useful financial innovation was the invention of the ATM is witty but it is not good economics: some financial innovation has surely done good just as Milton Friedman showed that speculation can be stabilising. But the fact remains that many today regard the financial sector as not just unproductive, but also counter-productive. This, in turn, has fed the revival in the public domain of the view that therefore manufactures must be supported. But this is a non sequitur. Even if you wished to reduce the size of the financial sector, you would not have to go into manufacturing. DHL and Fedex are, to recall Mr Jorgenson, very innovative; we do not have to encourage cement mixers. Non-financial services are no sweat, and produce little sweat, compared with a great deal of manufacturing. Finally, at least in America, the manufacturing sector attracts a lot of subsidies. States compete to attract manufacturing firms, with tax holidays, land grants and much else; few states do that for services or agriculture. Do we need to support the manufacturing sector even more, just because of shoddy arguments? |