Future of Industrial Policies

Part 4: The role of the primary sector and service sector in structural change

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Faculty of Economics, Thammasat University

(1) The role of the primary sector in structural change

The role of the primary sector in structural change

- Historically, many countries managed to set in motion their **industrialization process** through **various kinds of linkages** with the **production of primary commodities**.
- However, resource-rich countries have faced specific challenges associated with the "**natural-resource curse**", whereby their **wealth** of **natural resources reduces incentives for structural change.**
- There are also instances of **governance deficiencies**, **currency overvaluation** and excessive **external indebtedness**.
- The challenge is to be able to stimulate a process of **dynamic interaction** between the production and **export of primary commodities** and **structural transformation** involving economic diversification, including the **expansion of manufacturing activities**.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.

The role of the primary sector in structural change

- Even when the goal is to **reduce the share** of the **primary sector in GDP**, the sector can itself make an important contribution to that change in various ways that can **enhance the linkages** so **critical** to the **industrialization process**.
- **Forward production linkages** in primary production are a potentially **important source of raw material inputs** for processing in domestic manufacturing industries.
- They can help **increase processing activities** as a **first step** in the **expansion** of the manufacturing sector.
- Primary production also requires a variety of inputs of goods and services, some of which can be **supplied domestically** through **backward linkages.**
- Net exports of primary commodities can contribute to the **foreign exchange earnings** needed for **financing capital goods** imports for capacity expansion and **technological upgrading in the manufacturing sector**, thereby reducing the need for external borrowing.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.

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- **Higher incomes** in the **primary sector** also help **increase domestic demand for consumer goods**, some of which can be produced domestically, thus **generating demand linkages** for domestic production.
- The primary sector, especially oil and natural gas and mining, is a **major source of fiscal revenues** for public investment and for the provision of **public services**, including education and vocational training, public utilities and business services.
- Such public expenditure can finance **economic diversification** while also **crowding in** additional **private investment**.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.
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- Even more than in other sectors, the lack of appropriate policies to deal with **export-oriented commodity** production can **result in enclave-type activities** (particularly in **extractive industries**) and macroeconomic vulnerabilities.
- This generates particular types of **weaknesses** that have become evident at present after a decade of boom in global commodity prices and their subsequent decline.
- Thus, a period of higher prices and revenues from **primary exports** can **support economic growth**, but it can also lead to either **more structural diversification** or economic "**reprimarization**".
- A basic problem with such dependence on the primary sector is the **instability** of **international commodity prices**, which leads to booms and busts in export earnings.
- This introduces an element of **instability in public finances**, and thus in public investment that relies on such revenues.
- In addition, a **sharp rise of export earnings** during boom periods can lead to **exchange rate appreciations.**

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.

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- In the 2000s, many governments sought to mitigate the potentially negative impact of the **instability of export earnings** on **public finances** through new fiscal rules, such as limits on public expenditure and balanced or structural budget rules.
- These have generated mixed results. Some commonly cited successes are the **structural balanced budget rule** in **Chile** and the **sustainable budget index rule** in **Botswana.**
- This stipulates that current expenditure be financed only through **non-resource revenues**.
- Several governments established **commodity funds** to serve as a **buffer against revenue volatility** and as an instrument to **smooth fiscal expenditure** over time or for longer term savings for future generations, on the grounds that natural resources are finite.
- To prevent or **reduce exchange rate appreciation** that would **affect** the **competitiveness** of domestic **manufacturing industries**.
- Many governments sought to **manage the nominal exchange rate** through **currency market interventions**.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.

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- The generation or strengthening of **linkages between** the **primary sector and manufacturing** is receiving renewed attention.
- Ideally, these activities should **develop backward and forward production linkages**, in addition to **consumption** and **fiscal linkages**.
- **Backward production linkages** in the **extractive industries** can be promoted mainly through **local content requirements** or recommendations.
- They aim at **local employment creation** and the development of domestic production capacity to supply the commodities sector.
- In recent years, multinational enterprises (MNEs) themselves appear to have an interest in **increasing linkages**, as some inputs for their activities can be procured locally at lower cost, and also to fulfil corporate social responsibility requirements.
- But it is the role of governments to set or negotiate local content rules with MNEs, and promote cooperation between these firms and local firms to establish **a network of efficient domestic suppliers**.
- The potential for **backward linkages** appears to be even **greater in agricultural production** to the extent that efforts aimed at **output and productivity increases** in many countries lead to an increasing demand for relatively unsophisticated equipment and inputs that can often be provided by domestic firms.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.

(2) The role of services in structural transformation

The role of services in structural transformation

- Interest in the possibility of **services-led growth** may also result from the fact that **export-led industrialization** is becoming **more difficult**.
- An increasing number of producers from developing countries compete in a global market that is expanding much more slowly than when some countries successfully embarked on **export-oriented industrialization**.
- There is, however, **little evidence** of the highly heterogeneous **service sector**, by itself, playing the role of **engine of growth without a strong manufacturing base.**
- Some **modern services**, such as those enabled by ICTs, can **have positive impacts** on **structural transformation** similar to those that traditionally have been ascribed to manufacturing in terms of **productivity** and employment growth and **linkage creation**, including through international trade.
- On the other hand, services **embrace a broad range of activities**, from mostly low-skilled and low-productivity consumer services to high-skilled and technology-intensive business services.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.

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- In any case, the composition of the services sector matters in terms of its **contribution to employment** and **productivity growth**.
- **Low productivity** services, for example in **hospitality and personal care**, may help to create **employment for surplus labour**, but the gains in terms of overall **productivity** will be **low**.
- By contrast, high productivity services are, to a large extent, a reflection of the **high productivity growth** of **industrial activities**, and the **rising wages** and incomes that this helps to generate.
- Thus, in most cases, service activities have not emerged *sui generis*, but as an **offshoot of high-productivity manufacturing** activities, and at the same time they may **contribute significantly** to **productivity growth** in those manufacturing activities.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.

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- In countries where **industrialization has stalled**, **the movement of labour into service activities** has generally resulted from **inadequate employment creation** in the economy as a whole.
- In African countries, for instance, labour shifted into the services sector as employment creation in manufacturing weakened.
- However, much of the **value added in services** in **Africa** results from **low-productivity activities**.
- The services sector is therefore more likely to assume a **supporting role in accelerating structural transformation** in countries that also have a dynamic manufacturing industry and **fast productivity** and income growth, than in countries with **stalled industrialization** at a low level of industrial value added.

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- This is because the level of **income per capita is still too low** to generate a substantial **demand for more skill- and technology-intensive consumer services**.
- It is also because **manufacturing has not yet reached a stage** where it would strongly **drive a business service sector**, or where the latter could significantly contribute to productivity growth in manufacturing.
- This is in contrast to the **nature and potential** of **the services sector at the onset of deindustrialization** in **developed economies**, where **manufacturing has already grown** to account for a significant share of a country's GDP

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- The **tourism sector** has a **strong export component**, and can be a source not only of **job creation** but also of **foreign exchange**, and even for the generation of **backward linkages** to certain **manufacturing activities**.
- But while that sector relies less on domestic demand, its development requires appropriate **physical infrastructure**, and it has weak potential for **contributing to overall productivity growth** in an economy.
- Similarly, **attracting offshore services** of medium or **high value added** is likely to remain **out of reach** for **develop in countries** that **lack sufficient industrial** and technological capabilities.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.

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- Since the key **to productivity growth** and **upgrading of manufacturing** activities lies in sustained **capital accumulation**, a **favourable macroeconomic** policy stance.
- Also, a well-functioning financial system that provides **adequate long-term investment** are of the utmost importance for the **industrialization process** and the **realization of productivity gains**.
- Indeed, the **deterioration** of the macroeconomic and financial environment during the **1980s** and **1990s** was one, if not the main, **reason for the slowdown** of manufacturing and **productivity growth** in many developing countries.

Source: UNCTAD. (2016). The Catch-up Challenge: Industrialization and Structural Change. New York and Geneva: United Nations.