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Why Western Nations Need an Active Industrial Policy:

An Analysis of Deindustrialization and External Imbalances Europe

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Abstract

- The current financial crisis has revealed indisputably that it is not possible to maintain a large current account deficit indefinitely. When access to international capital markets becomes difficult – in periods of turmoil such as the current crisis – a large current account deficit becomes a critical problem.
- Empirical evidence suggests that the process of deindustrialisation – a process many Western countries are immersed in – leads to a deterioration of the trade balance and consequently, of the current account balance.
- In this article, we analyse the empirical relationship between external deficit and deindustrialisation. We find that a weak manufacturing sector is linked to an anaemic trade balance: as the manufacturing industry loses weight, the trade balance worsens. This cannot be compensated for simply through the positive evolution of the service sector.
- We highlight that some countries with an ample economic history in favour of laissez-faire policies are currently implementing policies to foster their manufacturing industries.
- Countries interested in promoting a healthy and relevant industrial sector will have to set out long term policies and instruments, such as: an R&D policy, a strong export policy, a small and medium business development strategy, a range of financial instruments to support the long term investment required by industry and a strategy for technical education.
- This set of policies and strategies would form the building blocks of government intervention aimed at increasing or at least maintaining the share of industry in GDP.

Introduction

Maintaining a persistent or chronic external deficit – of both current account balance and trade balance – is an emblem of many Western economies. Developed nations like the US or the UK have been dealing with this imbalance for more than twenty years. For example, the UK has not shown a positive current account balance on year basis since 1992, Spain since 1986, the US since 1992, Portugal since 1993, Italy since 2001 and France since 2004. Australia, Greece and New Zealand have not exhibited a current account surplus since 1980. However, a large and persistent external deficit is a problem that cannot be sustained indefinitely.

The counterpart of a current account deficit is a surplus in the balance of payment of exactly the same amount.[1] Countries with an external deficit require foreign capital to finance their growth and imports. A country can sustain a large external deficit for a very long period of time; however it is not possible to finance it indefinitely. Sooner or later, this deficit generates a sizeable external debt, which, in the long run, generates doubt in foreign investors. Ultimately, when these doubts arise, a sharp adjustment takes place. This adjustment is caused by a sudden stop in foreign financing[2], generating a devaluation of the currency, a recession of the economy, or an external default. Obviously, the risk of external default decreases significantly if the country's currency is an international reserve currency – like the United States.

This is obviously a zero-sum game: if a country is running an external deficit, another country (or countries) has an external surplus of the same amount. In other words, a chronic trade balance deficit is possible only if another country (or group of countries) runs a chronic trade balance surplus.

Chronic current account deficits are not a purely theoretical problem. Europe, for example, is immersed in a financial crisis, with great uncertainty, in particular, about the ability of peripheral countries to finance their external debts. In this context, countries like Spain, Portugal or Greece are unable to generate current account surpluses that would reduce the necessity of foreign savings. In 2012, and after five years of economic crisis, Greece had a current account deficit of 5.8% of GDP, Portugal of 2.9% and Spain of 2.0%. However, the peripheral economies do not stand-alone: the UK showed a current account deficit of 3.3% of GDP in 2012, despite the economic recession, and the US had an external deficit of 3.1%[3].

[1] The occasional differences between the two are due to variations of international reserves and statistical discrepancies.
[2] See Guillermo Calvo (1998)
[3] International Monetary Fund forecast.

One will find the opposite situation in a country like Germany, which has enjoyed a chronic current account surplus since 2001. Austria, the Netherlands and Denmark are other examples of European countries with persistent current account surpluses: the Netherlands has a current account surplus since 1981, Austria since 2001 and Denmark since 1999.

On many occasions these persistent external deficits are linked to a process of progressive deindustrialization. In order to illustrate this point, see the table of examples below:

Industry as percentage of GDP		
Country	**1970**	**2010**
France	35	19
Germany	48	28
Italy	39	25
Spain	40	26
United Kingdom	40	26
United States	35	20
South Korea	26	39
China	41	47

Note that this gradual process of industrial shrinkage is common to many Western economies, but it is not the case in other parts of the world, suggesting that this is not a worldwide model of economic growth and development. It is not accurate to affirm that economic development leads to a decline of industry in favour of services. In particular, South Korea – which has a per capita income similar to Spain – has a growth strategy that is clearly based on an expansion of manufacturing. Industry has flourished, from 26% of GDP in 1970 to 39% in 2010.

Clearly, the key question is whether or not deindustrialization and external deficit are linked. Some economic models differentiate two sectors: the tradable, subject to international competition, and the non-tradable, enjoying a monopolistic situation inside the country. The tradable sector is often associated with agriculture and industry, while the non-tradable sector is associated with the service sector. In these models, the non-tradable sector is by definition impossible to export. Logically, these models are a simplification of the economic reality, given that there are some services that are traded and exported, like tourism. However, it is undeniable that it is much more difficult to export a service than a good. In this context, the question that arises is: To what extent it is possible to deindustrialise a country without jeopardizing external balances? Are there limits to this process?

Controversy about the economic impacts of deindustrialization

The media and academic debate on the economic model capable of creating growth and employment is quite intense.[4] Without any doubt, the healthy status of the German economy – despite its position at the epicentre of the crisis lashing the Eurozone – is generating a plethora of opinions and a multitude of analyses. Despite the dire situation of most European economies, Germany would appear to be a safe haven, thus becoming a reference for financial markets. As is amply known, a robust manufacturing sector and a strong surplus of the current account balance are key characteristics of the German economy, representing an atypical case among Western countries. The share of the manufacturing industry in GDP in Germany is 20.9%, versus, for example, 10.7% in France, 11.4% in the UK, 12.8% in the US, 12.7% in Spain and 16.7% in Italy.

Remarkably, the US and the UK – countries typically and historically in favour of liberalism – are currently contemplating the necessity of a stronger manufacturing industry in order to increase exports. This thinking is gaining traction: on October 8, 2012, for instance, an article in the *Financial Times* entitled "America Reassembles Industrial Policy" asserted that "the US's manufacturing decline was an aberration that should be reversed". In the same vein, a recent report called *The Case for a National Manufacturing Industry* (Ezell and Atkinson, 2011) concludes that "despite those who would dismiss it, the fact is that a vibrant manufacturing sector is vital to the health and competitiveness of the U.S. economy. Moreover, the conventional wisdom - which holds that U.S. manufacturing establishment and job losses simply reflect productivity-driven restructuring - is wrong." This strong push for a boost to the manufacturing industry is a recent development, as pointed out by *The Economist* in 2010 in an article entitled "The Global Revival of Industrial Policy".

Political authorities in the United States and the United Kingdom are implementing a number of initiatives in order to foster manufacturing industries. In December 2009, the Executive Office of the President of the US published *A Framework for Revitalizing American Manufacturing*, which presents various plans and initiatives to boost the US manufacturing industry. Additionally, in 2010 President Obama created the Export Promotion Cabinet to develop and coordinate the implementation of the National Export Initiative, whose objective is to duplicate the export of American goods and services between 2009 and 2014[5].

[4] For example, in article entitled "El Mito de las Reformas en Alemania" ("The Myth of the Reforms in Germany"), published in newspaper El País on January 4th, 2013, Professor Holm-Detlev Köhler asserts that the success of the German economy during the crisis is attributable to its strong manufacturing sector and not to the economic reforms, as claimed by the German government.

[5] Note that the strong development and growth of the American unconventional natural gas industry could help to achieve this ambitious objective.

In 2012, the United Kingdom's Technology Strategy Board, a governmental agency, which aims to promote industry and technology, published a report entitled *A Landscape for the Future of High Value Manufacturing in the UK*. This report states that the UK must boost its high-technology manufacturing industry, presenting a detailed plan to achieve this goal. Another illustrative document is a letter dated February 8, 2012, written by Secretary of State of Business, Innovation and Skill Vincent Cable, to Prime Minister David Cameron. The letter, which was published in *The Telegraph*, explains the need for an active industrial policy to deal with the UK's economic problems. An illuminative excerpt is: "market forces are insufficient for creating the long term industrial capacities we need. Despite the biggest devaluation since the War, improvement in the UK's trade balance has been disappointing".

As described and exemplified above, numerous public administrations are carefully studying the situation of the manufacturing industry, as well as the state of the current account and of the trade balance. "Laissez-faire" policy on industrial issues is clearly under question.

Empirical evidence on deindustrialisation and external imbalances

In order to assess the impact of deindustrialization on external imbalances, we have carried out a detailed econometric analysis based on a panel data approach. In particular, we have used an unbalanced panel consisting of 38 countries for the period 1960-2010. We study the relationship between industry (more specifically, manufacturing industry), agriculture and services on the one hand, and trade and current account balances on the other.

The main results of our analysis[6] are the following:

- Countries with larger manufacturing industries tend to run either a surplus or smaller commercial and trade deficits. In particular, for each 1% increase in the share of manufacturing industry with respect to GDP, the trade balance improves by 0.9%. This strong impact confirms the intuition that a strong industry is an asset from the point of view of exports.
- Countries with larger service industries do not present significantly better figures on exports of services, implying that the balance of services and the size of the service sector seem to be independent. Economies based on services rather than industry are viable, and probably easier to foster. However, it is quite difficult to replace industrial exports with service exports, given the fact that services are not tradable, as our results show.

[6] For a detailed description of the empirical study see: Alejandro Legarda and Jorge Blazquez (2012).

To sum up our analysis, countries that have strong manufacturing sector (and, to a lesser extent, a strong agricultural sector) tend to have higher trade (and current account) surplus. On the contrary, countries with a strong service sector (or weak manufacturing industries and agriculture) tend to run trade deficits.

Conclusions

The financial crisis has revealed indisputably that a country cannot sustain a large external deficit indefinitely. Any country with a persistent current account deficit is forced to systematically finance itself on the international markets. In calmer times, gaining access to international financing is not a problem. But when an episode of turmoil takes place, current account deficit emerges as a serious problem.

Empirical evidence suggests that the process of deindustrialisation – a process many Western countries are immersed in – leads to a deterioration of the trade balance and consequently, of the current account balance. According to our empirical results, a weak manufacturing sector is linked to an anaemic trade balance: as the manufacturing industry loses weight, the trade balance worsens. In contrast, empirical evidence shows that a strong service sector does not automatically lead to a strong balance of services, with data showing that services are, in general, non-tradable.

This empirical evidence has relevant implications for economic policy. Many economists think that economic development necessarily entails a decrease in industry and agriculture in favour of services. Nevertheless, this process has its limits: if the economic policy and economic environment of a country favour services at the cost of industry, the economy reaches a threshold at which the country will become a victim of a chronic trade deficit. When this is reached, the country becomes forced to deal with a persistent external imbalance that hampers the economic health of the whole country.

To avoid this situation, countries interested in promoting a healthy and relevant industry will have to set out long term policies and instruments, such as an R&D policy, a strong export policy, a small and medium business development strategy, a range of financial instruments to support the long term investment required by industry, and a strategy for technical education. Together, these policies and strategies would form the main components of government intervention aimed at increasing or at least maintaining the share of industry in GDP.

It has been shown that countries with an ample tradition of laissez-faire, like the United States or the United Kingdom, are currently putting in place programs to foster the

manufacturing industry. These are undoubtedly innovative economic policies, considering these countries' trajectories. In fact, both countries are now convinced that the economy stands to benefit greatly from a more prominent presence of the manufacturing industry within the whole, and are designing strategies to follow this line.

At this point, and seeing as the paper is focused on Western economies, we wish to make an observation about Spain. Despite a very strong tourism sector, Spain is running a chronic current account deficit and suffering from a process of deindustrialisation. If countries with a strong tradition of liberalism, such as the US and the UK, are implementing policies to promote manufacturing industries, we wonder what is impeding Spanish authorities from promoting the country's industries.

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