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## ViewPoint

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### The Myth of Services

It has been a fashionable idea at different times and in different places that manufacturing matters less and less, that the service sector would replace any manufacturing losses. The loss is said to be a natural process, part of the historical transition from agriculture, through to industry and on to services, a natural process that nothing can or should be done about. This view is misguided and needs some careful thought. Are all services the same? What kind of services do we want to develop? Can New Zealand comfortably survive by exporting agricultural and other commodities and turning factories into back lots for the film industry?

It is worth recalling a comment attributed to Sir Angus Tait speaking on value add; "in order to create real wealth we can dig up something, grow something or make something" that gives an indication that the transition to services could well be a myth. We might also get a clue from the way other countries in the developed world have moved with increasing focus and vigour to support, develop and protect their own elaborately transformed manufacturing sectors – maybe they know something not generally recognised here?

The types of "service" that make up the service industry need a more accurate description. Services might be broadly grouped into consumer services (such as domestic services, hotels, tourism, health, government and lodging places), as distinct from producer services (for example; research, development, marketing, distribution, design systems, modeling software, information systems and business consulting). Are all these services equal? Are there associated dependences? For example, if cars did not exist there would be no need for the vast service framework that supports them – no car yards, no body shops, no filling stations, no dealers, spare parts supply, and as we know them roads and parking, this soon becomes an almost endless list.

With this in mind, there are perhaps different sorts of service, generally those that serve producers and those that support consumption. In another example, the information technology outsourced by a manufacturer is totally dependent on that manufacturer, so the crude classification of the information technology as either part of manufacturing or the service sector is completely arbitrary in this case. So thinking about consumer services as fundamentally different to producer services is a little more accurate than an overly simplistic global characterisation of “services”. In developed countries, a simple classification of manufacturing and service sectors is not applicable. A significant part of the output of the producer service sector is being used as input into other sectors, the largest of which is manufacturing.

A significant part of the “service” embedded in contemporary developed economies is entirely dependent on supporting the sectors that create and add value. A loss of the sector that adds value will inevitably lead to the loss of associated producer services with a correspondingly massive economic impact.

Some economies are well placed to exploit the growth in both consumer and producer services. Hong Kong, Singapore, and Luxemburg, spring to mind. Proximity to huge markets and product flows can see the virtual absence of production facilities, however such economies are special cases. New Zealand does not have the geopolitical characteristics to support this development option. The economy in New Zealand will only sustain growth in the long term by growing the capability and depth of value adding activity supported by world-class producer services – the loss of manufacturing will see the demise of many producer services and lead to a continued decline of in comparative living standards for New Zealand.

The Canterbury Manufacturers’ Association sees manufacturing as far more than the act of production. Manufacturing involves identifying a customer need, designing a full solution for that need, and then being able to sell the solution at a margin over cost that the customer is willing to pay. Put another way, Macpac no longer produces in New Zealand but Macpac is remains a New Zealand manufacturer.

In this mindset, the products become the vehicle to capture and subsequently sell intellectual property – one of the easiest and least management intensive ways of collecting the dues of invention and innovation. The economy needs the prime movers – digging, growing and making – without them all growth and the things we expect from the world, health, welfare, education will, over time, degenerate and Australia will be to New Zealand what England was to Ireland in the past.

So manufacturing and producer services are in many respects, complementary and interdependent activities. In modern economies, services tend to be “spun out” or outsourced from the manufacturing sector driven by process specialisation. They account for a large proportion of business services (product design, advertising, marketing, financial, accounting, information technology and legal services), as well as wholesale and retail sectors. It can be argued that these producer services are an integral part of the manufacturing process. Thus, it is incorrect to assert that, for the modern economy, the service sector will substitute rather than support and augment the manufacturing sector.

Manufactured products capture and channel intellectual property into the economy. In New Zealand, manufacturing accounts for 56% of research and development expenditure against services (much of which is as a supply to producers anyway) at 38% and agriculture at 6%. Manufacturing is also responsible for over one third of merchandise exports. It is also essential for any real pricing power – not commodities – in New Zealand’s export profile. The value from exported goods is about three times that of exported services from New Zealand.

Once producer services are included in the consideration of manufacturing a different picture emerges. Even the USA, seen by many as the most advanced economy on the planet, generates over 30% of GDP from manufacturing and services directly related to that manufacturing activity. It is not hard to imagine that service and manufacturing industries exist in a symbiotic relationship, without one the other may die. The leverage offered by the international trade in “tangible” products is less accessible in the services domain. In any event, in the absence of a manufacturing sector, a considerable portion of the producer service sector would disappear domestically and deprived of a domestic development base would be unlikely to generate any export markets.

How could local producer services develop, let alone trade in the international market without a domestic manufacturing development base in New Zealand?

Some economies have seen their manufacturing sector decline dramatically in light of local economic conditions. For instance, Hong Kong has seen its manufacturing sector contribution to GDP drop from 24% in 1980 to 4% in 2003, while the figure for service sector soared from 68% to 89%. It is often used as a typical case for arguing that the service sector can replace the manufacturing sector in an advanced economy. It does not follow that all economies should or can follow suit, and even the apparent pattern might not be correct. The increase in the service industry share in Hong Kong was almost totally due to the rise in producer service, in which a large proportion can be attributed to the business of manufacturing in China. The consumer service sector barely changed in that period, so, even in Hong Kong, the service sector can be conceived as an integral part of the manufacturing sector based in China. In addition, ease of flows in terms of goods and finance made Hong Kong better suited to be a “service” economy rather than that for producing goods yet its consumer services did not grow significantly in that period.

New Zealand does not have the “backyard workshop” such as the mainland China, or a favorable geographical location. A specialisation towards external producer service is simply not possible, and as seen in Hong Kong, independent growth of consumer services does not happen.

Service exports from New Zealand were only 26% of New Zealand’s total exports in 2003 and 40% of merchandise trade. Without the manufacturing sector, and hence its merchandise exports, it is unlikely that services trade could support New Zealand’s demand for imported goods. The current trade deficit is being financed by international investment that has encouraged the ballooning local asset prices - this cannot continue indefinitely.

It is also worth recalling that the manufacturing sector helps link the primary and service sectors to customers. In Australia, the manufacturing industry purchases the most inputs from other industries (such as mining, agricultural and services). The skills and capabilities developed in the manufacturing sector are necessary to add value on primary products (transformation) – the value to the economy of this cross sector connection should not be overlooked.

It is our view that, service substituting manufacturing is not a realistic expectation, or indeed a natural progression for all developed economies. All other developed economies have in place a raft of interventions that support their manufacturers. Local policy makers need to recognise that the game is lost once the attitude blossoms that there is nothing to be done but accept the inevitable that manufacturing is a “sunset” sector, and that the future is services. Giving up on manufacturing will see the global mobility of the sector take effect. In such circumstances, New Zealand can anticipate a continued slide in comparative living standards. Do we want that or do we work for, develop and apply policy that can help prevent it?

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