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Manufacturing in developing countries benefits from quality service firms

Services firms can help manufacturing grow in developing countries. But the quality and technological competence of those companies is what matters most when it comes to positive spillover effects. The simple existence of service firms isn't enough to make a difference for manufacturers.

In addition, countries which allow more open trade in services can expect to see a greater benefit for their manufacturing sector, and that is especially true for low-income countries.

The makeup of manufacturing companies is also a factor in whether they will benefit from contact with services firms.

Those are the main findings of a recent working paper for the Asian Development Bank Institute, which looked at the spillover benefits that service firms can have on manufacturing.

A recent study by the Organisation for Economic Co-operation and Development found that services represent at least 30% of the value added in manufacturing exports. Services are a big factor in the emergence of global value chains. Quality control, logistics, storage facilities, packaging, insurance, and distribution are all services that help smooth global trade.

The existence of quality service firms can help low-income countries move up the value chain. In the apparel sector, for example, manufacturers can use services to shift from simply cutting and sewing fabric into designing and marketing their own brands.

The working paper looked at 38,000 manufacturing and 24,000 services firms in 105 low- and middle-income countries to understand the links that might best help manufacturing.

It found that just having a large number of service firms in a region or having a service sector that makes up a large share of a region's output was not enough for manufacturing to benefit. It was when service companies had better-than-average worker productivity and more intensive use of technology that manufacturing saw the most positive spillover effects.

The paper found that a 1% increase in median services productivity in a region was related to a 0.23% increase in manufacturing labor productivity.

That spillover effect could be aided by countries which liberalize the service sector. That involves removing barriers to entry for local or foreign services firms, privatizing state-owned enterprises and abolishing monopolies. That forces existing service providers to either up their game or leave the field, the study notes.

Allowing foreign service firms to operate in a country is important. The study found that foreign ownership and a top manager's experience in the sector were the top two factors leading to the high worker productivity and technological intensity that in turn led to the most spillover effects.

The makeup of the manufacturing companies was also important. Large, foreign-owned exporters were the manufacturers who benefited most from the spillover effects.

The paper suggested that governments should consider policies that encourage upgrades to technologies and skills for service firms, rather than those that aim to support all service-sector companies.

Those policy interventions would likely have the greatest effect in low-income countries. Spillovers from high productivity were larger in upper middle- and low-income countries while middle- and low-income countries saw the biggest benefit from technology spillovers.

This podcast was based on *Productivity Spillovers from Services Firms in Low- and Middle-Income Countries: What is the Role of Firm Characteristics and Services Liberalization?* *a* working paper for the Asian Development Bank Institute by Deborah Winkler, senior consultant and principal at Global Economic Policy LLC.

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