UNITED NATIONS
INDUSTRIAL DEVELOPMENT ORGANIZATION

INDUSTRIAL DEVELOPMENT REPORT 2018
BRIEF NO 3

The domestic demand for manufacturing in a global economy

Executive summary

Final demand for manufacturing goods is a key driver of economic activity. Demand for final goods propagates across all sectors of an economy, spurring agents to engage in activities that are directly and indirectly related to manufacturing production. When final demand—which, in interconnected economies, originates both domestically and abroad—is met domestically, it gives impetus to income growth at the national level. When it is met by imports, income leaks to producers in source countries. Balancing between domestic and foreign sources of demand is crucial for countries attempting to industrialize.

Key findings

- Final demand for manufactures is primarily driven by domestic absorption. In 2013, domestic absorption represented about 84% of manufacturing final demand at the world level. In developing and emerging industrial economies this share is higher and, following a period of decline in the 1990s, it is growing again. Thus, emerging countries appear to be 'rebalancing' towards the domestic market.

- A demand-side perspective magnifies the contribution of manufacturing to GDP. In all country groups, the value added induced by the consumption of manufacturing goods exceeds that which is directly generated in production.

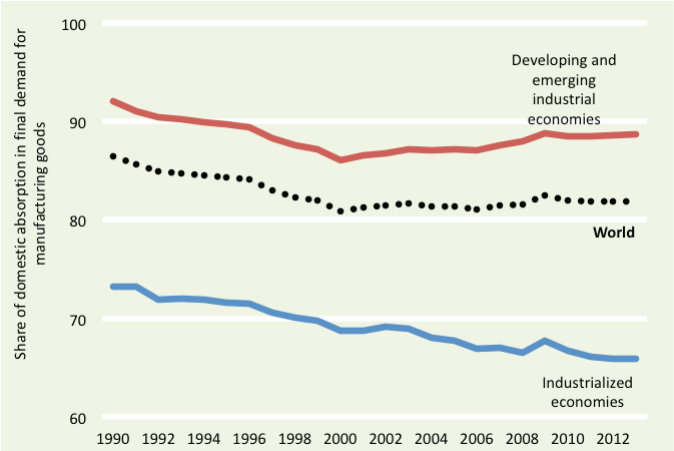
- Domestic demand mobilizes greater GDP growth in developing and emerging industrial economies than it does in industrialized countries, as these are more reliant on international markets. Yet the contribution of domestic demand to GDP growth has increased for all country groups—with the exception of Europe—between 1990 and 2013.

Is globalization reducing the importance of the domestic market? In the main, no

In a globalized economy, demand for goods, capital and labour crosses national borders leading to an increasing dislocation between consumption and production. In this context, catering to international markets has become a mainstay of industrial development strategies in developing countries. The domestic market, however, remains an important source of profits and learning for manufacturing firms.

Indeed, at the world level and across country groups, final demand for manufacturing is primarily driven by domestic absorption. This in spite of the acceleration in the globalization of trade and production since 1990, which increasingly reduces the gap between the domestic and foreign components of demand—particularly in industrialized economies (the blue line in Figure 1).

Figure 1 – Domestic absorption as a share of final demand for manufacturing goods



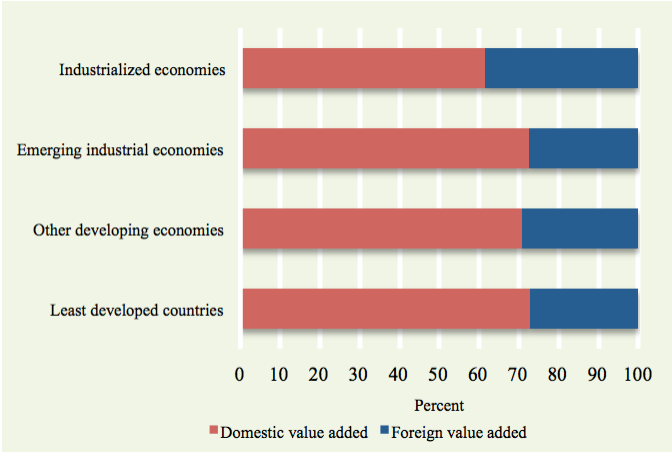
Note: Each line shows the unweighted average of the indicator for the world and country groups.

Source: Adapted from UNIDO IDR 2018, Figure 3.1, page 66.

In emerging economies (the red line in Figure 1), by contrast, the importance of domestic absorption has picked up steam again in the 2000s. This reflects the 'rebalancing' of large export-oriented economies, such as China, towards the domestic market. Rebalancing implies that, in these countries, a growing share of national income is generated by catering to domestic consumers.

Industrialized economies are also more integrated in international trade and production. As countries industrialize and increase their participation in global value chains (GVCs), products that are produced and consumed at home start embodying more components sourced from abroad (Figure 2). In other words, as they grow richer countries increase their participation in the production and consumption of other countries.

Figure 2 – As countries integrate in the global economy, domestic goods embody a greater share of foreign components



Note: The bars represent the domestic and foreign value-added components of final manufacturing goods produced and absorbed domestically. Values refer to the unweighted average, by country group, for the year 2013.

Source: UNIDO IDR 2018, Figure 3.5, page 69.

How does domestic demand for manufacturing contribute to prosperity?

Final demand generates new incomes: some at home, some abroad

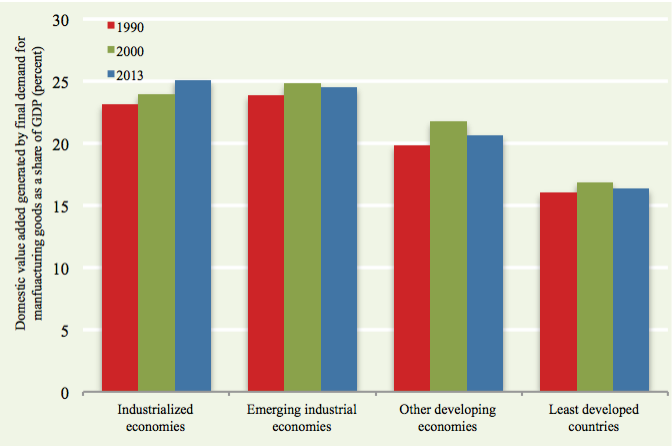
All economic activity is, in one way or another, tied to a specific source of final demand. Demand for any type of good, ranging from consumer products to equipment purchased by firms, sets in motion a chain of activities that, if successful, generates new incomes—in the form of profits and wages—across all sectors of the economy.

Final demand for automobiles, for instance, triggers further demands for a variety of primary materials (such as steel or rubber), intermediate inputs (such as car engines), and downstream activities (such as marketing or logistics). In interconnected economies, each value- and income-generating activity is 'added' along the value chain, by certain industries in certain countries.

Using multi-regional input-output tables (Box 1), one can estimate how much value added does final demand for manufacturing products—at the world level—induce domestically, and how much of it 'leaks' abroad. The focus here is not on the value-added generated within the manufacturing sector, but rather on that which is induced by consuming its products.

The final demand for manufacturing goods is an important contributor to GDP (Figure 3). At the world level and across country groups, the contribution of final demand for manufacturing to GDP (DVAMAFID) exceeds that of manufacturing value added (MVA). Moreover, in contrast with MVA, DVAMAFID increased from 1990 to 2013.

Figure 3 – Final demand for manufacturing contributes to between 15 and 25 percent of GDP across country groups



Note: The height of each bar represents the share of domestic value added generated by manufacturing final demand in GDP. Values refer to the unweighted average, by country group, for the year 2013.

Source: UNIDO IDR 2018, Figure 3.6, page 70.

Box 1. Slicing up GDP using input-output analysis

A country's GDP is the sum of all value added generated in each sector of the economy. Conceptually, this is equivalent—in the aggregate—to the sum of domestic absorption plus net exports. The intuition is simple: final demand, at home and abroad, induces the creation of value added domestically. It does so directly, by stimulating the production of final goods, and indirectly, by generating demand for intermediates and inputs.

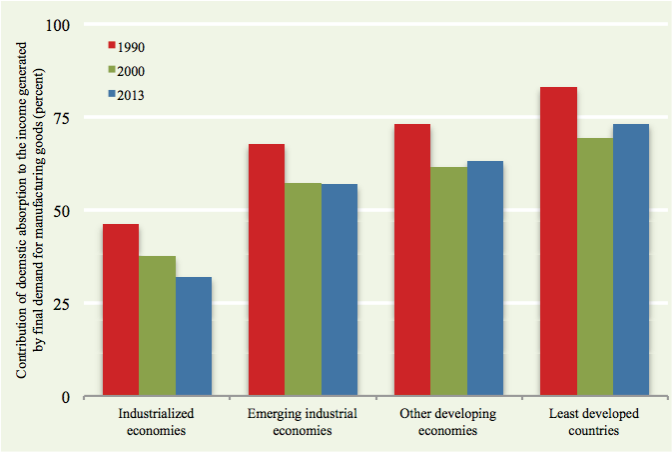
Now, estimating the relative weight of the domestic and foreign components of final demand, and their respective contribution to GDP, represents an analytical challenge because of the growing complexity of GVCs. Most of what is produced and consumed at home embodies components sourced from abroad—and vice versa. Multi-regional input-output tables can be used to overcome this difficulty.

De Macedo and Lavopa (2017) apply a decomposition methodology to the EORA input-output database, enabling to trace each bit of value added that is embodied in final goods back to its country of origin (as shown in Figure 2). This method also allows to estimate with greater accuracy the domestic value added which is induced by domestic and foreign demand for final manufacturing goods by netting off imports, as these induce income creation in source countries rather than domestically (Figures 3, 4, and 5).

The changing role of domestic demand across countries…

Domestic value-added is generated as a result of the final consumption of manufacturing goods, regardless of whether consumption takes place domestically or abroad. The two components, however, have different weights in different countries. While in industrialized economies—which are more integrated in GVCs— foreign demand accounts for well over 50 percent of DVAMAFID, in all other country groups the domestic component plays a greater role (Figure 4). This suggests that, relative to developing and emerging economies, industrialized countries generate a larger share of their GDP by producing for consumption in other countries.

Figure 4 – The contribution to value-added of the portion of final absorption taking place domestically exceeds that of foreign absorption in all country groups, with the exception of industrialized economies.



Note: The height of each bar represents the contribution of domestic absorption to the income generated by the final demand for manufacturing goods. Values refer to the unweighted average, by country group, for the year 2013.

Source: UNIDO IDR 2018, Figure 3.7, page 71.

…and over time

The contribution of the domestic and foreign components of final demand to domestic value-added also varies over time (see Figure 5). In each panel, a movement towards the right indicates a higher growth rate induced by final demand for manufacturing between two periods (1990-2000 and 2000-2013). Movements towards the upper side, on the other hand, indicate that growth is driven to a larger extent by domestic consumption.

Europe is the only region where the contribution of domestic demand to growth appears stable or in decline. In other regions, it appears to be growing over time. However, while in Asian and African countries the movement towards the domestic market is associated with rapid value-added growth, the opposite holds for Latin America—a reflection of the different growth dynamics in the three groups over the past two decades.

Overall, this provides further evidence of rebalancing. In the past decade, all country groups—with the exception of Europe—have displayed greater reliance on the home market to mobilize GDP growth, a trend opposite to that observed during the previous decade.

Conclusions

» The domestic absorption of final manufacturing products is the most important component of final demand, at the world level and across country groups. As countries get richer, however, its relative importance diminishes, as exports of final manufacturing goods increases.

» Domestic demand for manufacturing is also a key driver of income generation. This is particularly the case in developing and emerging industrial countries, where its importance relative to foreign demand has been growing in recent years.

» Following over a decade of export-led growth, emerging industrial economies appear to be gradually rebalancing. This means that in these countries, consumption at home plays a growing role in driving domestic value-added and income growth.

References and suggestions for further reading

De Macedo, A. C., and Lavopa, A. 2017. 'Tracing Incomes Generated by Domestic and Foreign Demand for Manufacturing'. Background Paper for the Industrial Development Report 2018. United Nations Industrial Development Organization (UNIDO). Vienna.

Mayer, J. 2016. 'Towards a New Normal Growth Strategy: China in Comparative Perspective'. Journal of Chinese Economic and Business Studies, 14(2), pp. 107-128.

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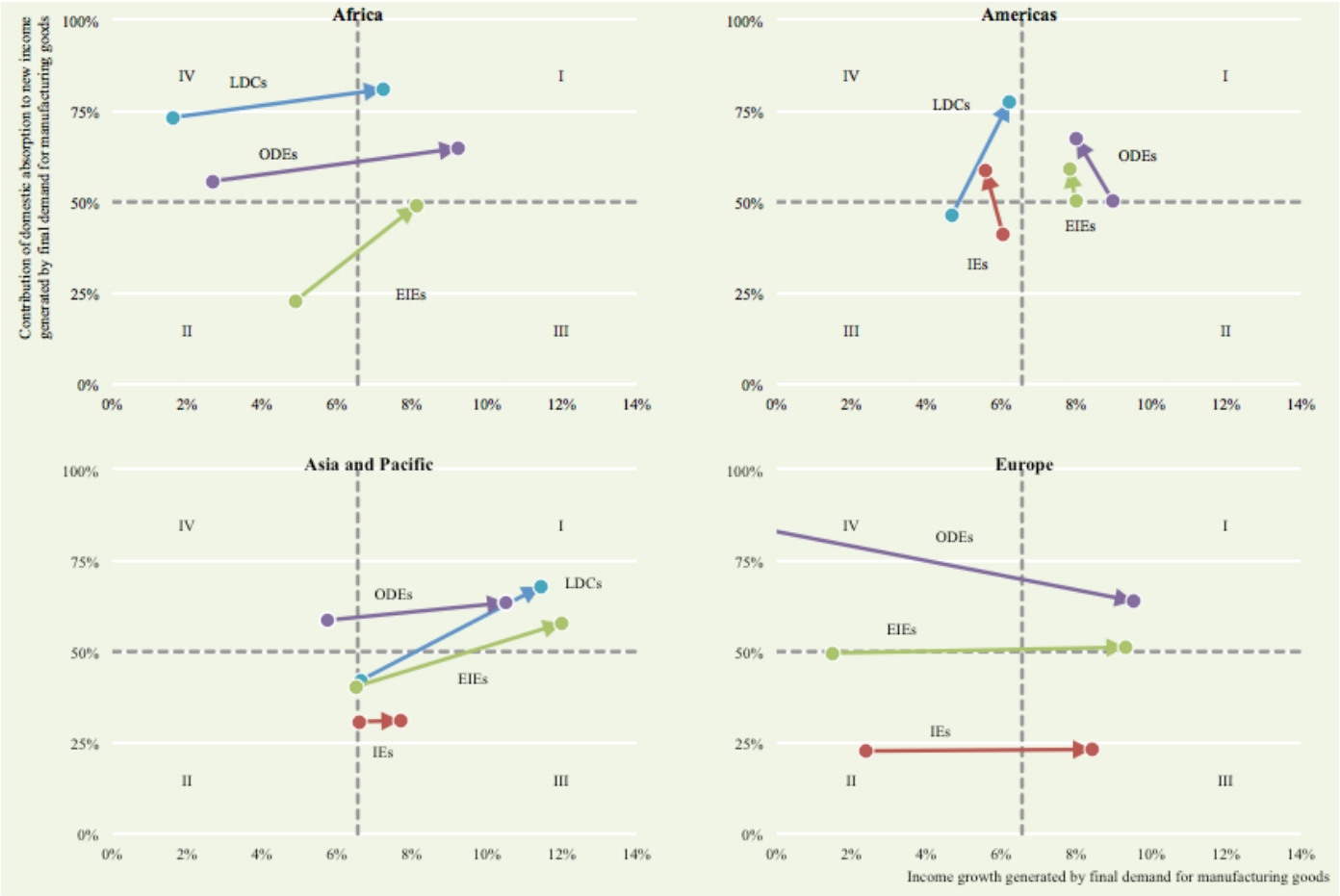
Figure 5 – With the exception of Europe, there is evidence of rebalancing towards the domestic market. This is accompanied by growth acceleration in Africa and Asia, but not in Latin America.



Note: Values refer to the unweighted average, by country group, for the periods 1990-2000 (starting value) and 2000-2013 (ending value). Growth refers to the annual compound growth rate of each period, and income is proxied by domestic value added. The dashed vertical line indicates the average growth rate observed across the different regions; the dashed horizontal line indicates the average contribution of domestic demand. Using these two averages, one can distinguish four stylized cases: (1) rapid growth with high reliance on domestic demand (top right quadrant); (2) rapid growth with low reliance on domestic demand (bottom right quadrant); (3) slow growth with low reliance on domestic demand (bottom left quadrant); and (4) slow growth with high reliance on domestic demand (top left quadrant).

Source: UNIDO IDR 2018, Figure 3.9, page 72.