ARTNeT POLICY BRIEF

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Facilitating Services Trade in the Asia-Pacific

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Services Trade is an Increasingly Important Economic Force

Services account for the bulk of all economic activity in advanced economies, and their contribution in developing countries is increasing. Asia-Pacific economies are no exception. Services value added represents up to 90 per cent of all economic activity in Hong Kong, China, over three-quarters in the United States, and over two-thirds in Australia, Japan, New Zealand, and Singapore. Even in developing economies such as Viet Nam and the Philippines, services account for over one-third and one-half respectively of total value added in the economy.

Key messages

- *Services account for a large share of GDP, but a relatively small share of total exports.*
- *Increased services trade promises major economic gains, including economy-wide spillovers.*
- *Results from a gravity modelling exercise suggest that reforming services policies, including through regional integration, could provide a major boost to trade.*
- *Policymakers should focus on reducing the full range of trade transaction costs in services sectors through a holistic approach to regulatory reform. Trade transaction costs include regulatory measures that create barriers to market entry by foreign service providers, or additional cost burdens for foreign firms.*
- *Future policy reforms should pay particular attention to "backbone" sectors with strong backwards and forwards linkages, such as transport, retail/distribution and logistics, and telecommunications.*

Advances in information and communication technologies (ICTs) have fundamentally altered the view that many services fall into the "non-tradable" part of the economy. **It is becoming increasingly possible to trade services across borders.** The rise of business process outsourcing is one important example. It is now feasible for a New York-based investment bank to achieve around-the-clock processing of market research and other information by splitting operations across different time zones. Functions such as web design, accounting, and telephone-based or online customer service can now be efficiently and reliably performed overseas.

Measuring international services trade is more difficult than for goods trade, since the GATS recognizes four "modes of supply": pure cross border trade (Mode 1), movement of the consumer (Mode 2), sales by foreign affiliates (Mode 3), and movement of the service provider (Mode 4). Standard balance of payments data are most closely related to GATS Modes 1-2 only. Nonetheless, the available evidence suggests that **international trade in commercial services has undergone spectacular growth in recent years.** In current US dollar terms, it more than tripled over the 1995-2008 period. There was a sharp upturn in the growth rate of services trade in the early 2000s. It persisted through 2008, but has slowed somewhat since then due to the effects of the Global Financial Crisis. Asia-Pacific economies are no exception to this trend, and have essentially tracked the same pattern of growth as the world as a whole over the 1995-2008 timeframe.

Increased Services Trade Promises Major Economic Gains...

Pure cross-border trade in services has a strong analogy with inter-industry goods trade: as trade is liberalized and transaction costs fall, trade flows increase and specialization by comparative advantage takes place. The one-off increase in economic welfare is of the same nature as in goods trade, and is based on a reallocation of resources without allowing for any dynamic effects such as productivity increases. Trade via GATS Mode 1 conforms most closely to this paradigm.

More recent models of international trade incorporate product differentiation and heterogeneous firms, i.e., they allow for firms to produce different product varieties, and for firms with different levels of productivity to co-exist within each sector (Chaney, 2008). Trade liberalization has an additional effect in this framework. It causes low productivity firms to contract or exit the market due to increased competition from foreign producers. This process leads to a transfer of labour and capital towards larger, more productive firms that are better able to face competition from overseas. Overall sectoral productivity increases. Miroudot et al. (2010) show that a 10 per cent reduction in the trade transaction costs facing service providers is associated with a 0.5 per cent increase in sectoral total factor productivity (TFP), and a nearly 0.1 per cent increase in the rate of TFP growth. This result sits well with the literature on goods trade, in which, for example, Chile's trade liberalization was found to be

* This Policy Brief presents results and policy implications from a recent study of trade in services in the Asia-Pacific region (Shepherd and Van Der Marel, 2010). Ben Shepherd is the Principal of Developing Trade Consultants Ltd and the advisor to ARTNeT. The views presented are those of the author and do not necessarily reflect the views of the United Nations or other ARTNeT members and partners.

associated with productivity gains of between 3 per cent and 10 per cent (Pavcnik, 2002).

Trade in services also has a range of other economic benefits that are less strongly emphasized in the analysis of goods markets (Figure 1). **Services are an important input into many production processes elsewhere in the economy.** One example is the logistics and distribution sector. Better logistics performance is strongly correlated with trade outcomes in goods sectors, and in particular parts and components trade that takes place within international networks (Arvis et al., 2010). Countries with stronger logistics performance also tend to be more open to trade, and experience faster economic growth.

Figure 1. Direct and indirect economic effects of more liberal services policies

Source: Shepherd and Van Der Marel (2010).

Regulatory reform that, among other impacts, reduces trade costs in services sectors therefore leads not only to improved resource allocation through specialization, but also to significant "knock on" effects in other parts of the economy. **Productivity in manufacturing can be increased as a result of gains in service sector efficiency** (Arnold et al., 2008), which can result in improved competitiveness. Blyde and Sinyavskaya (2007) find that, on average, a 10 per cent increase in total services trade is associated with a 6 per cent increase in total goods trade. They find that the strongest gains for manufacturing exports come from improved efficiency in transport and communication services.

An additional set of spillovers from services trade come from the important role played by FDI and trade via GATS Mode 3 (sales by foreign affiliates). There is ample empirical evidence that **foreign-owned companies tend to be larger and more productive than their domestic counterparts, particularly in developing economies.** For instance, Arnold and Javorcik (2005) find that foreign-acquired plants outperform a control group by 13.5 per cent in terms of productivity after three years.

There can also be substantial **technology spillovers from FDI,** as well as skill upgrading in labour markets. Since FDI is an important vehicle for services trade, this dynamic is suggestive of an additional set of productivity gains that can be reaped by improving service sector productivity, including through additional efforts at trade liberalization.

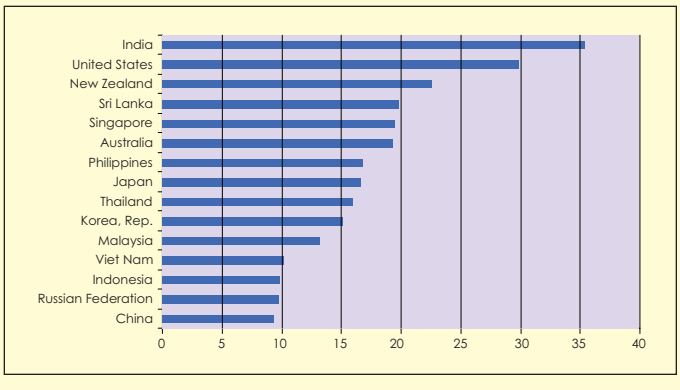
At the macroeconomic level, there is evidence that these spillover effects matter for subsequent economic growth. Hoekman and Eschenbach (2005) find that liberalization of backbone services such as finance, infrastructure, telecommunications, power, and transport, is highly correlated with inward FDI. Moreover, they find that these policies explain a significant part of the post-1990 growth path of transition economies. Similarly, Mattoo et al. (2006) show that economies with open telecommunications and finance sectors tend to grow about 1.5 percentage points faster than other economies.

… But Only a Small Fraction of Services Output is Actually Traded

Despite the increasing tradability of services and the major economic gains that can result, **the proportion of services that are actually traded remains relatively small in most economies** (Figure 2). The fact that services trade is generally under-reported due to the difficulty of measuring trade under GATS Mode 3 is only part of the story. Another important part of the explanation is that the overall transaction costs involved in trading services are relatively high.

Trade transaction costs come from many sources. Some can be referred to as "natural", in the sense that they reflect inherent factors such as geographical distance, or linguistic and cultural differences. There is relatively little that governments can do to compress these types of costs, although reform of the transport sector can obviously help reduce the "tyranny of distance". Another part of the overall transaction costs affecting services trade stems from certain policy measures and regulations, which are amenable to substantial change through government action. Many regulations affecting trade in services are legitimate and relatively efficient, but others could be designed and implemented in such a way as to achieve important economic or social gains at lesser economic cost. In particular, regulatory measures that either create barriers to market entry by foreign service providers, or place additional cost burdens on foreign

Figure 2. Service exports (BOP, current US$) as a percentage of exports of goods and services (BOP, current US$), 2008



Source: World Development Indicators.

firms, can unduly restrict international trade. Re-regulating so as to compress these types of costs can be an important way in which policymakers can lower the costs of international trade in services, and thereby promote trade among Asia-Pacific economies.

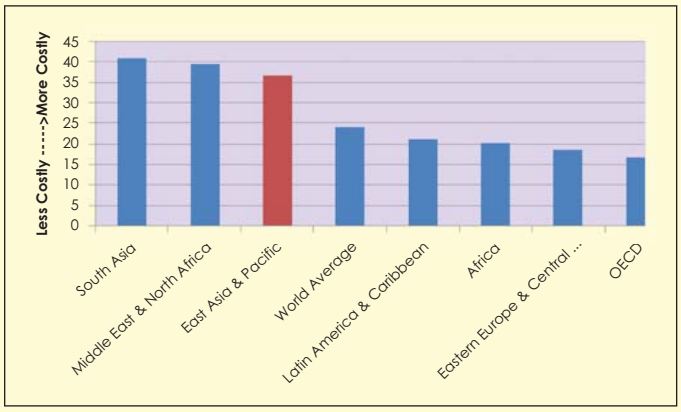
From the early 2000s to 2009, however, **exports of services have increased at a much faster rate than services value added.** A relatively low initial level can only explain part of this pattern. As in goods markets, trade growth that is much faster than output growth can be seen as a sign of increasingly integrated international markets: globalization and/or regionalization of economic activity. Integration of services markets is therefore becoming an increasingly important aspect of overall economic integration.

Services Trade Policies in the Asia-Pacific are Relatively Restrictive

The fact that services represent a much smaller proportion of total exports than of GDP suggests that there may be policy factors that raise trade transaction costs and hold back the development of international services markets. Such factors fall broadly into two groups: those that limit market entry by foreign services providers, and those that raise the cost burdens on foreign firms serving a given market. For instance, a limitation on the number of foreign companies allowed to enter the market falls into the first category, while a requirement that foreign operators pay a special tax on remitted profits falls into the second category.

Measuring restrictions to trade in services is very challenging, and only limited data are currently available. The World Bank is compiling data on the kinds of services policies mentioned in the previous paragraph for 56 industrialized and developing economies, including Asia-Pacific economies. Those data are not currently available on a disaggregated basis. Gootiiz and Mattoo (2009) provide aggregate results from their survey, which provides a useful place to start in assessing Asia-Pacific policies in comparative perspective (Figure 3).

Figure 3. World Bank trade policy index in services

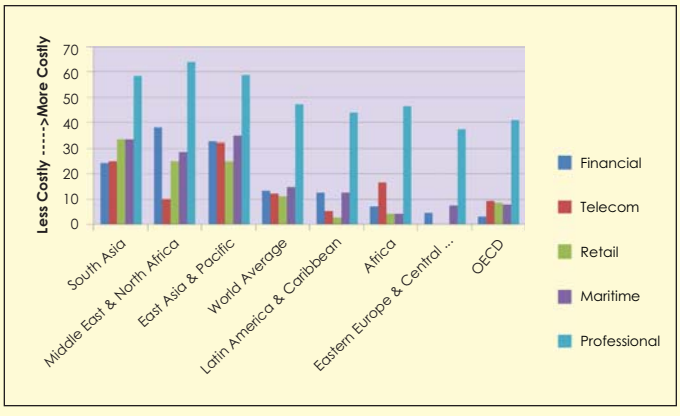


Source: Gootiiz and Mattoo (2009).

The main conclusion to emerge from Figure 3 is that **services markets in the Asia-Pacific are relatively restricted compared with other regions,** and even with the world average. The level of restrictiveness is considerably higher than in Latin America or even Africa, for example. Based on these data, it is likely that policy-related trade transaction costs are relatively high. This indicates there is a lot of room for Asia-Pacific economies to facilitate trade in services – and enjoy the corresponding economic gains – through targeted regulatory interventions in this area.

As with all types of trade-related policies, there is considerable scope for heterogeneity in the nature and extent of services-related regulatory measures across sectors. The World Bank dataset presented by Gootiiz and Mattoo (2009) covers five sectors: finance, telecom, retail, maritime, and professional services. As Figure 4 shows, **the East Asia and Pacific region again appears quite restrictive relative to other regions.** In particular, professional services sectors are subject to relatively high regulation-related trade costs compared with the other sectors. The least restricted sector is retail.

Figure 4. World Bank trade policy indices by sector



Source: Gootiiz and Mattoo (2009).

Gravity model results suggest that reducing the restrictiveness of service sector regulation can provide a major boost to services trade (Shepherd and Van Der Marel, 2010). As an example, improving Korea's performance on one indicator of services sector restrictiveness – the OECD's Product Market Regulation (PMR) indicator – by around 20 per cent could increase its trade by over 50 per cent. Another significant result from the gravity model is that **membership of an RTA/FTA is strongly associated with increased trade flows in services.** As a rough order of magnitude, the model suggests that economies that are members of an RTA/FTA trade perhaps twice as much as those that are not.

How important is policy as a determinant of services trade flows, as compared with other factors? The strongest determinant of trade patterns is exporter and importer market size (GDP). But policy factors such as the restrictiveness of regulation and membership in RTAs/FTAs also play an important role. Removing all policy variables from the gravity model noticeably reduces its explanatory power: around 6 per cent less of the observed variation in trade flows is accounted for by the model without policy variables. That number is higher than the reduction in explanatory power that takes place when geographical and historical variables are excluded from the model.

In other words, **policy appears to be a significant source of trade transaction costs in the services domain, and is probably more important than "natural" trade costs such as distance.** Policymakers therefore have a major role to play in helping reduce policy-related transaction costs, and facilitating trade in services.

What are the Policy Priorities Going Forward?

Policymakers have a major role to play in facilitating trade in services in the Asia-Pacific region. Performance varies substantially across sectors and economies, but on an overall level, the latest World Bank data suggest that the Asia-Pacific has a relatively restrictive trade in services environment compared with other regions. It will be important to continue to deepen our understanding of any policy measures that might create undue and unintended trade costs.

Policymakers should concentrate on the following points going forward:

- **Trade facilitation for services** – i.e., reducing the transaction costs affecting international services trade – should be an important part of overall liberalization and economic integration efforts.
- Given the complexity of the regulatory arrangements affecting services trade, it is important for policy-makers to take a **holistic approach to reform.** Economy-wide measures, as well as sector-specific ones, need to be considered, and complement each other.
- **Backbone services sectors** such as transport, retail/distribution and logistics, and telecommunications should receive particular attention as part of a balanced reform package, since they have the greatest potential to generate economy-wide spillovers.

Future policy initiatives in this area could perhaps take a leaf from the APEC trade facilitation playbook. The idea would be to identify sets of concrete policy steps that economies can, if they wish, commit to implement in order to reduce trade costs in services markets. Actions could be organized around the two main types of trade costs in this area, i.e., those that tend to restrict market entry, and those that add to the cost burden facing current operators. They could be cross-cutting or horizontal in scope, or sector-specific. Future sector-specific studies could be a useful way of identifying a range of measures that could be implemented.

There are also important ways in which future work on services can interact with policy moves in other areas. Trade facilitation, including logistics performance and supply chain connectivity, is an example. Improving service sector performance in logistics, transport, and distribution can be an important part of broader efforts to reduce trade transaction costs across the region. There is major scope for policymakers to facilitate this process by identifying priority outcomes and putting in place programmes of activities designed to progress towards them.

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