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Volume Author/Editor: Takatoshi Ito and Anne O. Krueger, editors

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Author: Takatoshi Ito, Anne O. Krueger

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Introduction

Takatoshi Ito and Anne O. Krueger

Until recently, analysts of economic development thought of the process as one in which activity gradually shifted from agriculture to industry. Developed countries were regarded as industrial countries, that is, having large industrial sectors and relatively small agricultural sectors. Over the past several decades, however, it has become apparent that after a stage in development in which shifts of resources occur between agriculture and manufacturing, there comes a point when services growth accelerates and outweighs growth in manufacturing and industry as per capita incomes continue rising.

In the United States, for example, manufacturing accounted for 15.2 million jobs and 25.8 percent of total employment in 1950; by 1970, the corresponding figures were 19.4 million and 24.7 percent; by 1990, they were 19.0 million and 16.0 percent; and by 1998 they were 18.8 million jobs and 15 percent of total employment. Whereas less than half of all jobs were in services in 1950, by 1998, 76.4 percent of all jobs were in the service sector in the United States.[1] Indeed, even if one speaks of all goods-producing activities (including construction and mining), the picture is little different; and the same general pattern is being followed in other industrialized countries.

Although the weight of services industries has increased in the economy, trading of services was not historically considered to be important. Indeed, many products of the services industries have been regarded as "nontrad-

Takatoshi Ito is a professor in the Institute of Economic Research at Hitotsubashi University, Tokyo, and a research associate of the National Bureau of Economic Research. Anne O. Krueger is first deputy managing director of the International Monetary Fund and a research associate of the National Bureau of Economic Research.

1. Data are from Council of Economic Advisers, *Economic Report of the President*, February 2000, tables B-33 and B-44.

able." Economics textbooks are full of examples and anecdotes, from haircuts to city bus services. It used to be the case that in many countries electricity, telephone services, and water and sewerage networks were provided by the national monopoly and not considered to be tradable. Producers and exporters used to use their local banks, contract with local shippers, and buy their insurance from domestic firms, and they either sought local contractors or themselves provided other services in-house. Today, however, the greatly reduced costs of transport and communications have meant that many previously domestically produced services can now be obtained internationally. As technologies and competition policies have changed, these services have also become tradable. International airline services and international telephone services have been hotly contested trade disputes. By the late 1990s, penetration into domestic service sectors by foreign companies became commonplace for large construction projects and financial services as well.

There are four types of service trades according to the General Agreement on Trade in Services (GATS), which came into being as part of the Uruguay Round agreement. GATS was established to join the General Agreement on Tariffs and Trade (GATT) as part of the World Trade Organization (WTO). The four types are (a) cross-border supply in which services can be produced in one country and delivered to another; (b) consumption abroad, when domestic residents go abroad to consume the services (such as tourism); (c) activities provided to foreign nationals by foreign branches and subsidiaries of domestic firms; and (d) relocation of natural persons. The first category includes services flows from the territory of one country to another. For example, air transportation to carry foreigners is counted as an export of a service. Banking services supplied to foreigners transmitted via telephone or mail are also service exports. The second category includes such items as ship repairs and aircraft maintenance abroad. These first two types of cross-border trade are typically captured in the balance-of-payments statistics.

However, services trade is not limited to cross-border transactions. When firms and natural persons physically move abroad to provide services, that is also service trade. This would include foreign subsidiaries of insurance companies, hotel chains, department stores, and the like. These activities are not usually captured in the balance-of-payments statistics. The fourth category includes professionals (consultants, accountants, doctors, teachers, programmers, architects) who physically move abroad (and expect to return to their own countries) to provide services. When income is repatriated, this may or may not be captured in balance-of-payments statistics.

Reflecting the growing importance of services in industrial countries' gross domestic products (GDPs) as well as the reduced costs of trade in services, services trade (and especially business services) has grown more rapidly than merchandise trade in recent years. From 1990 to 1998, the value of world exports of merchandise trade rose at an average annual rate of 6.8 percent, whereas the value of trade in services rose at an average annual rate of 8.0 percent. The share of services in total international trade in goods and services has been steadily rising and reached 19.8 percent in 1998.[2]

As the importance of services has grown, economists have increasingly focused on policy issues raised by them and have sought to understand what, if any, differences there are between production and delivery of goods and of services.

A fundamental difficulty is the problem of identifying services output. If a manufacturer has a bookkeeping department that does the billing, the economic activity is regarded as part of the manufacturing. If, instead, the manufacturer hires an outside firm to do the same task, it is regarded as a service. The inability to split up activities into their goods component and their service component is one difficulty in coming to grips with services. A second problem arises because of the difficulty of measuring services output. Although matches, candles, and other goods may not be identical, estimating the quantity (or volume) of output (in terms of units such as weight) independent of its price is relatively straightforward, and there are means by which adjustments for quality can be made.

When, instead, the output of a firm is a service, there seems to be little way of measuring output other than by the value of the inputs (salaries of employees, rents, interest payments costs, etc.). Hence, it is difficult to disentangle the productivity of inputs into services industries because there is no separate measure of output. In turn, that makes many aspects of services activities difficult to measure and to understand.

As employment and output of services have increased as a proportion of GDP, it has become increasingly recognized that some services—such as accountancy, financial services, and so on—are generally provided to business users. Thus, the quality, timeliness of delivery, and other attributes of services are increasingly important as a determinant of a country's comparative advantage: exporters who must wait weeks for freight forwarders to ship their goods are at a strong competitive disadvantage, as are those who must rely on high-cost banking services relative to their foreign competitors.

Two interesting questions arise in this regard: on one hand, it can be asked how the availability, quality, and timeliness of services affect the comparative advantage of other traded goods industries; on the other, issues arise with regard to the degree to which there exists comparative advantage among countries with regard to the provision of services.

Although little is known about the first question, ignorance did not seem important until the cost of trading services internationally fell markedly.

2. Data are from World Trade Organization, *Annual Report 1998 International Trade Statistics*.

When it did fall, immediate questions arose as to the gains to be had from liberalizing trade in services. Because it is in the nature of services trade that the traditional instruments of trade policy do not constitute the major protective barriers, it is not surprising that little was known about the costs and benefits of services liberalization.

Internet trading, e-commerce, financial services, and a host of other services are now readily tradable internationally. However, the barriers to services trade—often initially erected in connection with regulation of domestic service providers when international trade in services was not economic—are different from those to trade in goods. Licensing regulations, regulatory environments (such as bank supervision), and a host of other impediments to services trade differ significantly in their nature from the tariffs and quantitative restrictions that the GATT and WTO have so successfully brought down.

To complicate the matter further, changing technologies have affected the nature of and the need for regulation. Just as the costs of overseas phone calls have dropped sharply, technological change has affected the feasibility of competition among firms in what was once regarded as a natural monopoly. Consequently, regulatory regimes are often themselves outdated by virtue of technological change at the same time that efforts are being made to liberalize trade in services.

Despite the paucity of our understanding of these issues, policy makers are moving ahead with deregulation of services domestically and liberalization of international trade in services. In this volume, we bring together thirteen papers that were presented in the eleventh annual East Asian Seminar on Economics, which took place on 22–24 June 2000.

The first set of papers gives overviews on the issue. The paper by Philippa Dee, Kevin Hanslow, and Tien Phamduc uses their newly developed comprehensive data set on trade barriers to services to estimate the costs of these barriers. They first consider the nature of these barriers (see their table 1.1) and the measures that can be used, depending on the type of restriction to trade. They then estimate the tariff equivalents of these barriers for nineteen countries (one of which is a group of four Latin American countries) for services imports and exports.

With these data, they then estimate the partial equilibrium effects that would occur with removal of these barriers to trade and foreign investment in services. They use these results to better understand the ways in which removal of barriers to trade and investment in services would affect primary, secondary, and tertiary activities in the various countries. Their estimates generally indicate that liberalization of services trade would contribute more to the world economy than is widely thought, although the authors give ample warning that the data are a "first pass" and that a great deal of additional research is needed both to improve estimates of barriers to trade in services and to improve the model from which the estimates are derived.

They also note that it seems—at least, based on their results to date—that the biggest gains to liberalizing trade in services would originate in the services industry itself, although in many countries there would be positive benefits for other sectors of the economy as well.

In his valuable paper, Aaditya Mattoo assesses the prospects for liberalization of trade in services through the GATS. He believes that multilateral cross-sectoral liberalization of services trade—through, for example, requiring national treatment for all foreign services providers—is not feasible. However, as he demonstrates, much could be achieved by more limited measures, such as the requirement that services barriers meet a "necessity": a test showing that the mechanism chosen is the least costly for achieving a desirable social objective (insuring that medical qualifications are adequate, for example). Mattoo's analysis illustrates both the problems inherent in achieving open multilateral trade in services and, despite the obstacles, the feasibility of achieving significant gains in further multilateral services liberalization.

Richard H. Snape analyzes the political economy aspects of the services trade deregulation. With the Snape paper, the reader is reminded of the importance of the political economy. The link between the objectives of policies and policy instruments is not so straightforward as economic theory suggests. The paper asks, "could stated policies justify what has been done in regulating service industries?" The paper consists of two sections: a discussion on whether negotiation should be generic or sector-specific and an examination of the correspondence between policy objectives and policy instruments. An ultimate objective and a stated objective can be differentiated, and optimal instruments to achieve an ultimate objective are examined.

The second set of papers investigates the economy-wide trade liberalization impact on the economies of Taiwan, Korea, and Hong Kong.

The paper by Ji Chou, Shiu-Tung Wang, Kun-Ming Chen, and Nai-Fong Kuo discusses the impact of Taiwan's WTO accession on the economy, using a general equilibrium analysis. Objectives of the paper are fourfold. First, Hoekman's method of estimating tariff equivalents in services trades in Taiwan is discussed. Second, a computable general equilibrium model is employed to estimate impacts of liberalization of services trade. Third, the paper analyzes technological spillovers from advanced countries to developing countries embodied in imports of intermediate inputs. Fourth, impacts from WTO accession by Taiwan and Mainland China are measured.

The Li-min Hsueh, An-loh Lin, and Su-wan Wang paper discusses the growth of Taiwan's services trades. The paper offers a good overview on the time-series changes of Taiwan's services trades. The paper shows that "increases in the imports of goods and per capita income, and decreases in the relative prices of import services, are major contributors to the growth in import services." It also finds that "the trade in goods, per capita income levels, and the relative price of services are three important determinants of the services trade found in our regression analysis."

The Jong-Il Kim and June-Dong Kim paper examines the impact of service liberalization on productivity and growth in Korea. The Kim and Kim paper investigates the impact of service-sector liberalization on productivity in the distribution sector itself and the manufacturing sector. Changes in labor productivity and total factor productivity (TFP) of the service and manufacturing sector are tabulated. Although some correspondence between liberalization and productivity increase in the service subsector (or the manufacturing sectors that use service-sector input) is suggested, it is weak, partly because liberalization took place only recently and full effects may not have materialized.

Although there has been much discussion of liberalization of services, and especially of financial services, there has been little empirical work at the microeconomic level that assesses the importance of barriers to trade in services and the potential benefits to their removal.

In their paper, Clement Yuk Pang Wong and Anming Zhang begin to fill this gap by analyzing the perceptions of the Hong Kong business community of the effects of restrictions on services trade on their economic prospects. To do this, the authors sent out a questionnaire to a number of Hong Kong businessmen. They then tabulated their results and, in addition, interviewed the respondents. They asked businessmen to indicate which types of liberalization would be most beneficial for them, and Wong and Zhang report the responses in their paper. Financial services was the area in which most businessmen thought that further liberalization would have the biggest benefit for them. However, business services and information technology services were not very far behind. Interestingly, at least for Hong Kong, transport services was a sector in which little benefit was expected from further liberalization of the sector.

The third set of papers deals with a specific service sector of a specific country. In their paper, Nae-Chan Lee and Han-Young Lie consider the liberalization of Korean telecommunications in the context of the WTO agreements. Until the end of the 1980s, Korean Telecommunications (KT) had a monopoly of telephone services, and the main objective of Korean telecoms policy was to provide universal access. Once that was achieved, there was an initial, relatively timid, market opening, but it met with considerable resistance from KT. The Uruguay Round agreement then provided the impetus for considerable reform, including permission for foreign ownership and competition in the domestic market.

Analysis of the role of the WTO in furthering liberalization is difficult because the Asian financial crisis also affected telephony at the same time that deregulation was taking place. Nonetheless, Lee and Lie point to the major benefits to consumers that have arisen due to liberalization and find the telecoms market today much more competitive and open than it was in 1997, when the second round started.

The area of financial services is one of the focuses of efforts to liberalize services trade. It has been prominently featured in Uruguay Round and subsequent negotiations, and many analysts believe that there are very sizable benefits to be gained by financial liberalization. In their paper, Sang In Hwang, Inseok Shin, and Jungho Yoo review the literature on the benefits and costs of services liberalization and then apply that analysis to the case of Korean financial services.

Korean financial liberalization came about only slowly until the 1990s. Then, after the Uruguay Round and, more importantly, accession to the Organization for Economic Cooperation and Development (OECD), liberalization accelerated. Before it had gone very far, however, the Asian financial crisis erupted. In response, the Korean authorities accelerated financial liberalization. The authors first present an account of financial liberalization in Korea at its various stages and document the changes made in the 1990s.

Hwang, Shin, and Yoo then attempt to assess the positive and negative impacts of financial services liberalization in Korea from the time of the Asian financial crisis until 2000, but find that three years is too short a time from which to reach very many firm conclusions. They cannot find evidence that the presence of foreign banks improved the efficiency of financial intermediation, although they point out that that does not prove that there were no such improvements. Likewise, any benefits that might have taken place because of improved financial intermediation have been overwhelmed by the effects of the financial crisis in Korea.

The area of tourist services is one of the most rapidly growing areas of international trade in services. In most regards it is also one of the areas to which there are fewer trade barriers, in part because foreigners come to the country that exports the services and in part because most countries want to attract tourist expenditures. In their paper, Kuo-Liang Wang and Chung-Shu Wu study the determinants of the relative tourist flows to eight Southeast and East Asian countries from the United States and Japan.

They show, first, that barriers do matter: When China began to encourage tourists, the attractiveness of other destinations in the region fell. Second, individual tourist decisions appear to be quite responsive to changes in the relative costs of different tourist destinations, although business and group tourism is less so.

Southeast and East Asian countries have been increasing their share in the world tourist trade. Although the Want and Wu paper investigates the relative competitiveness of tourism among regional destinations, much work remains to be done to understand the determinants of the overall share of the region in the world's rapidly growing tourist industry.

Among services, there has been considerable attention devoted to accounting. Calls for international standards have come from those who believe they are important for strengthening financial services and corporate governance in developing countries as well as from those who seek more transparency to encourage foreign direct investment (FDI) and to enable meaningful comparisons across countries. Accounting services were among those services pinpointed in the GATS, which set forth guidelines for services liberalization, and standards are in the process of being agreed upon.

In his paper, Fukunari Kimura provides an analysis of some of the difficult issues involved in liberalizing accounting standards and services in the case of Japan. Although he covers only accounting, the nature of the problems that are encountered in liberalizing services trade is similar for many other areas.

By the 1990s, the Japanese accounting system had become "increasingly incompatible" with modern corporate management, especially in using the book value of assets and treatment of affiliates. It was also incompatible with the emerging International Accounting Standards (including provisions preventing foreigners from qualifying to undertake accounting services in Japan), and an "accounting Big Bang" is planned, led by the Business Accounting Council of the Ministry of Finance. Three major reforms are contemplated: consolidating financial statements, calculating assets based on market values, and adding cash flow statements to income and balance sheet statements. Kimura reports on the many difficulties and resistances that are encountered and the very significant changes that are likely to follow in management practices as a consequence of the Big Bang.

The fourth set of papers extends a usual concept of service trades measured in the balance-of-payments (BOP) statistics. The paper by Shujiro Urata and Kozo Kiyota carries out an interesting analysis of services trades. First, services trades (BOP-based net exports, exports, imports) are regressed on factor inputs (capital, labor, and human capital) in order to investigate the validity of Heckscher-Ohlin predictions. The authors find that the explanatory power of the Heckscher-Ohlin theorem on the patterns of service trade is quite limited. The authors guess that the failure of theory is due to the presence of restrictions and barriers and intraindustry trade due to product differentiation. Second, the authors investigated services trades embodied in goods trade (indirect services trade). Using the input-output table, they estimate service input contents for traded goods. The authors compared embodied services trade and disembodied services trade. The ratio of embodied services trade to total services trade is low for the Philippines and high for China. For Japan, disembodied services imports exceed disembodied services exports; that is, services trade in the BOP statistics shows deficits. However, embodied services trade surpluses are large enough to more than offset disembodied services trade deficits. The situation is the opposite for Singapore. Then the authors calculated the service contents for 1 million dollars' worth of goods exports and imports for East Asian countries. They found that they are similar for Japan, Singapore, Taiwan, and Malaysia. However, when the indirect trade ratios for exports and imports are compared, the authors found that Singapore and Taiwan "export services through goods trade," whereas Japan, Malaysia, the Philippines, and China "import services through trade." Although Japan is a developed country, services trade shows deficits. The "anomaly" may be explained by the Japanese preference for the consumption of services (including imports). By sectors of total (embodied and disembodied) trades, Japan is a net importer of electricity, gas, water supply, and education and research, and a net exporter of wholesale and retail and transportation services.

Kyoji Fukao and Keiko Ito use the FDI data, based on the Toyo Keizai firm-level database, in order to estimate activities through foreign subsidiaries and affiliates. Fukao and Ito investigate sales and employment of Japanese affiliates of foreign firms (JAFFs) and foreign affiliates of Japanese firms (FAJFs) in the service sector at the three-digit industry level for the year 1995. They also compare Japan's purchase of services from foreigners with U.S. purchases from foreigners. Their findings indicate that foreign activities in Japan are much greater than those reported in the Ministry of International Trade and Industry's survey on Japanese subsidiaries of foreign firms. The study suggests that the frequently cited FDI statistics of Japan, which rely on cross-border capital flows on the reporting basis, grossly underestimate activities of foreign affiliates in Japan. However, when activities of foreign firms in Japan are compared to those in the United States, the latter are much larger than the former.

The last two papers are complementary in deepening understanding of services trades beyond just the measured balance of payments. The Urata and Kiyota paper calculates the embodied (indirect) services trade, using the input-output table, as well as the disembodied (measured in balance of payments) services trade. Although this type of embodied service is not a concept covered in the GATS, it provides us with new information to reconsider what Heckscher-Ohlin predictions mean with respect to services trade. The Fukao and Ito paper directly addresses the third aspect of the GATS services trade concept, namely, activities through subsidiaries and affiliates abroad. Taking advantage of the rich data set, the authors describe Japanese affiliates abroad and foreign affiliates in Japan in much more detail than before. These papers push the frontier of the services trade literature forward.