Implications of the Growing Role of Services in Asia

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This article analyses the importance of international commercial service transactions relating to both trade and investment, which form an essential element of analyzing production fragmentation and economic integration in Asia. Following an aggregative analysis the authors discusses data generation tasks to reflect the importance of cross-border service transactions.

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I
Introduction

There appears to be an emerging consensus that while some aspects of current phase of globalization, particularly those relating to unfettered capital flows and more liberal immigration regimes are likely to undergo significant changes, internationalization of the economies is expected to continue. This is because internationalization is driven by technological changes, by economic factors which provide real savings in resource costs, and which help sustain competitiveness of businesses. This is also evident in the unfolding of the Asian economic integration process.

An important facet of current internationalization trends in Asia and elsewhere is the growing scope and quantitative importance of cross-border commercial service transactions, and of cross-border investments in the services sector. Advancements in Information and Communications Technology (ICT) have played both direct (in terms of software and other services trade), and an indirect (by reducing information transmission costs significantly to make off shoring of increasingly wide range of services economically viable) role in the rapid growth of this sector.

There is increasing receptivity by both the investing and recipient countries to permit cross-border investments in the services sector. These go beyond traditional tourism related investments to include such areas as roads, ports, airports, education services, stock and commodity exchanges, banks, and ICT related activities.

The share of services in GDP, employment, investments, and value-added is high and increasing in most countries including in Asia. According to the figures from World Trade Organization (WTO), in 2005, the total value of commercial services trade was

USD 4760 billion, equivalent to 23 **per cent** of global merchandise trade. As six of the top 20 leading exporters and importers of services in the world are Asian (Table 1), services have an important role in intra-Asia and global economic linkages.

The importance of cross-border services in trade and investment is expected to continue, including in Asia. Opportunities for off shoring have been far from exhausted particularly as new ICT technologies continue to become operational. As per capita incomes increase, given the income elastic nature of services, demand can be expected to rise more than proportionately. In contrast, income elasticity of merchandise trade is lower, and therefore with rising world incomes, importance of services trade and investments can be expected to increase.

In Asia, a rigorous analysis of cross-border trade and investment in services is also relevant in the view of ongoing efforts towards regional economic cooperation and integration. Several Asian countries, including India, are proposing or negotiating bilateral and regional comprehensive economic partnership agreement that aims to liberalize and facilitate international trade in commercial services. As an example, India has a bilateral agreement with Singapore, called the Comprehensive Economic Cooperation Agreement (CECA) that includes service trade liberalization. Singapore has negotiated a number of bilateral services trade agreements as part of its FTA efforts. Other Asian countries, such as India and Japan are also pursuing broader economic agreements, which include services.

On a regional basis, China has also signed a similar agreement with ASEAN (Ten member Association of Southeast Asian Nations), India, Japan, Korea, Australia and New Zealand. These 16 countries participated in the annual East Asian Summit (EAS) which began in 2005. The EAS includes all the major countries of Asia. It therefore represents more logical, credible, and coherent forum to enhance Asia's weight in global affairs than sub-regional arrangements.

As EAS countries engage in bilateral and multilateral economic arrangements and agreements with Asian and non-Asian partners, it is worth emphasizing that it is the utilization rates of these agreements which will determine their impact. Care must also be taken to ensure that such agreements and implementation integrity do not unduly increase transaction costs of cross-border trade and investments.

An important characteristic of the cross-border trade in services is that they are difficult to quantify. This is not only due to its intangible nature resulting in problems of definition, but also due to inadequate analytical and physical resources devoted to documenting and tracking it nationally, regionally, and globally. In contrast, extensive research, national and international efforts, and resources have gone into analyzing and documenting merchandise trade.

It is therefore not surprising that the available statistical data on service transactions are not comprehensive, nor timely and sufficiently disaggregated or internationally comparable. The current data therefore inadequately reflect the magnitude and structure of international trade in services.

Services transactions are based on four modes of service provision. But the available data in the public domain are largely restricted to services trade that takes place through the first two modes, i.e. cross-border supply and consumption abroad. The services trade being undertaken through commercial presence (Mode 3) and temporary movement of natural persons (Mode 4) remain incomplete and not easily available.

The usefulness of the services trade data is further limited by the absence of bilateral trade data on services. An unfortunate consequence has been the tendency on part of the academics, researchers, and policymakers to overemphasize merchandise trade. This has led to inappropriate analytical and policy conclusions, particularly in the areas of production fragmentation and integration.

The data on cross-border investments in services are also less well documented than for the manufacturing and mining sectors. Countries usually do not publish bilateral service investment data, particularly on an actual as compared to approved basis.

This article analyzes the importance of international commercial service transactions relating to both trade and investment, which form an essential element of analyzing production fragmentation and economic integration in Asia. The case of India is particularly instructive as relatively greater importance of its service sector internationally has led many analysts to incorrectly conclude that it is not as deeply integrated in the production and economic networks in Asia as some of the other countries whose total international trade in goods and services is far smaller than India's. The paper highlights is organized as follows. Section 2 provides an aggregative analysis

of cross-border service transactions, including trade, investments, and remittances. This is followed by a brief discussion of implications of services trade for analyzing economic integration (Section 3). Section 4 discusses data generation tasks to reflect the importance of cross-border service transactions. The final section provides the concluding observations.

II

An Overview of Cross-Border Services Transactions

Table 1 provides data concerning leading exporters and importers of commercial services in the world for the year 2005. These are based on information provided by various national statistical organizations to the World Trade Organization (WTO).

Table 1: Leading Exporters and Importers in World Trade in Commercial Services, 2005

Rank	Exporters	Value (US $ billion)	Share (per cent of world total)		Rank	Importers	Value (US $ billion)	Share (per cent of world total)
1	United States	354.0	14.7		1	United States	281.2	12.0
2	United Kingdom	188.7	7.8		2	Germany	201.4	8.6
3	Germany	148.5	6.2		3	United Kingdom	154.1	6.6
4	France	115.0	4.8		4	Japan	132.6	5.6
5	Japan	107.9	4.5		5	France	104.9	4.5
9	China	73.9	3.1		7	China	83.2	3.5
10	Hong Kong, China	62.2	2.6		12	Korea, Republic of	57.7	2.5
11	India	56.1	2.3		13	India	52.2	2.2
16	Singapore	45.1	1.9		16	Singapore	44.0	1.9
18	Korea, Republic of	43.9	1.8		20	Hong Kong, China	32.4	1.4
24	Australia	27.7	1.1		21	Taipei, Chinese	31.4	1.3
25	Taipei, Chinese	25.6	1.1		22	Australia	28.9	1.2
28	Thailand	20.5	0.8		23	Thailand	27.5	1.2
29	Malaysia	19.0	0.8		27	Indonesia	23.2	1.0
	World	2415.0	100.0		29	Malaysia	21.6	0.9
						World	2345.0	100.0

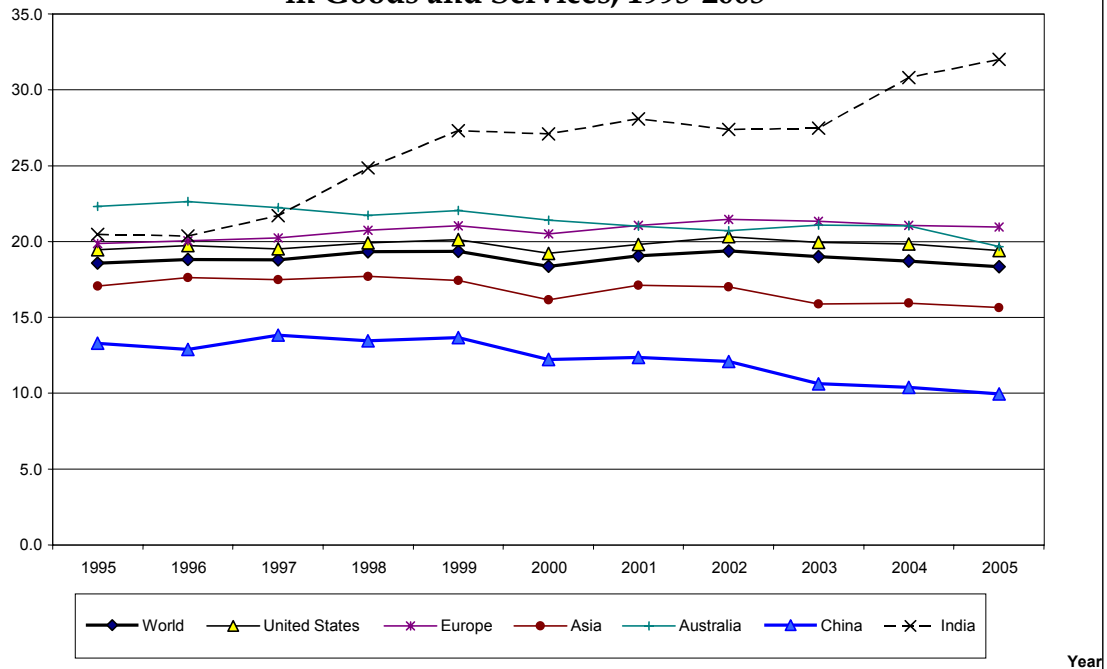
Source: Adapted from *WTO International Trade Statistics 2006.*

The following observations may be made on the basis of data in Table 1:

US ranks 1st in global trade in services with US $ 635.2 billion. Among the EAS countries, Japan ranked 1st with total services trade of US $ 240.5 billion. It is followed by China (US $ 157.1 billion) in the 2nd position, and India (US $ 108.3 billion) in the 3rd position. India's ranking is likely to improve further as its competitiveness in the information technology outsourcing industry increases, and discovers its potential in healthcare, tourism and education services trade, which is only beginning to be exploited.

i) Among the EAS grouping, eight countries, viz. Japan, China, Korea, India, Australia, and ASEAN-4 countries rank among the top 30 global players, with a combined share of nearly a fifth of global trade in commercial services. India with a total commercial services trade of US $ 108.3 billion, ranked as the 11th largest global exporter and the 13th largest global importer of commercial services respectively.

Figure 1 : Share of Services in Total Trade in Goods and Services, 1995-2005



Source: Computed from *WTO International Trade Statistics 2006.*

Figure 1 provides the shares of services trade to total trade in goods and services for major economies globally over 1995-2005. It may be observed that while this share is in the range of 15-25 per cent for most economies in the world and in Asia, it increased from about 20 per cent to 32 per cent over the past decade in the case of India. This is not to suggest that India can or should rely on services sector as primary engine of growth. Indeed, India is already emphasizing the manufacturing sector. There is also increasing realization that greater focus on agriculture, and on linkages between agriculture, manufacturing, and services sector is essential to sustain India's high growth.

Foreign Direct Investment (FDI) in Services

The role of FDI in services trade of Asian countries has been increasing significantly in recent year. This is a reflection of increasing opening up of the services sector in Asia and the world. It also reflects increase in offshoring activities and temporary movement of persons in many services sectors such as ICT, finance and insurance, education and professional business services. In many cases offshoring involves FDI as well. FDI in services is reaching newer areas. As an example, India received US $ 625 million in foreign direct investment (FDI) in its stock and commodity exchanges between January and March 2007, and this is expected to increase (*Financial Times*, March 15, 2007).

However, rigorous research for individual countries as well as cross-country analysis of the contributions of such investments to trade generation and economic integration process is yet to materialize.

Cross-border Remittances

Remittance flows may be regarded as arising from cross-border manpower services. According to the 2006 World Bank document, *Economic Implications of Remittances and Migration,* remittances play an important role in several Asian countries, most notably China, Vietnam, Philippines, Thailand, Bangladesh, Myanmar, and India.

Remittances formed 13.5 per cent of GDP in Philippines, the highest in Asia. India received US $ 21.7 billion worth of remittances from abroad in 2004-05, equivalent to about 2.8 per cent of its GDP, and 39 per cent of India's total export of services.

The remittance figures in the document are understated as they capture only a fraction of income generated from Mode 4 related services trade. Also, as the document suggests, given measurement uncertainties (notably the unknown extent of unrecorded flows through formal and informal channels), the true size of such flows may be more than one and half times the official estimates. The country variations in the official estimate, and therefore in underestimates, are likely to be considerable.

While remittances are useful, the key is the extent to which they impact positively on enhancing the trend rate of economic growth. This is because too large a flow of remittances reflects lack of domestic opportunities for the workers, and lack of utilization of manpower for domestic development. So while a degree of cross-border labor mobility is healthy, too large a flow could be dysfunctional.

III
Implications for Analysis of Economic Integration

The increasing quantitative and qualitative importance of cross-border transactions suggests a need to re-define and re-think the nature of production networks and of economic integration.

East Asia's integration with the global economy was driven by export-oriented production networks in manufactured goods. This is reflected well in merchandise trade data. When services transactions were relatively small, and when services elements in manufactured goods were not qualitatively important, the focus on merchandise trade to analyze production network and economic integration was perhaps defensible.

Integration of India with the global economy, which is undoubtedly more services and technology oriented, is not captured by conventional merchandise trade data.

Few examples may illustrate this point clearly. Intel's India centre contributed complete design of the Centrino mobile chip called Napa (*The Economic Times,* November 2, 2006) that will be subsequently incorporated in a variety of electronic products. Such non-trivial design work should logically be regarded as part of the overall

value chain in the process of production fragmentation. The merchandise trade flows are recorded by gross amounts rather than value-added. The design work's importance therefore may not be fully reflected in the conventional trade data.

India is aiming to be one of the centres for car design In Asia. To the extent such work is translated into actual car production globally, it should be regarded as an integral part of the motor-vehicle production fragmentation. More than 250 of the Fortune 500 companies in India are undertaking research that may lead to future high technology products. While their actual contribution in trade value terms may be relatively small, India nevertheless constitutes a vital part of the electronics production, research, distribution, and customer servicing chain. India is currently drawing 25 per cent of fresh global investments in R and D centres (*www.ibef.org*).

Indeed, it has been persuasively argued that dynamic new centres of technology entrepreneurship, extending Silicon Valley system to distant locations in India, China, Israel, and Taiwan[i] are creating cross regional networks and communities which are an integral part of the global integration and competition. These are unfortunately, not recorded by gross merchandise trade flow data, thereby undermining perceptions about the true extent of India's international competitiveness in the global market. Such perceptions substantially understate the qualitative and quantitative dimension of India's economic integration with the rest of Asia.

IV

Data Generation Tasks

The above discussion therefore suggests a strong case for broadening the scope of production network and fragmentation definitions, found in the current literature, in order to incorporate the contribution of services trade. The analysis so far strongly suggest that sound policies and business strategies concerning the services sector are greatly facilitated by robust, high quality, timely, and disaggregated data.

Several important data generation tasks lie ahead for Asian countries and for the global institutions. First, the existing data itself is highly aggregated, and more sector-specific data need to be generated. Second, and perhaps most important, there is an urgent need to collect and disseminate information of bilateral services trade among

Asian economies, especially in the light of the ongoing regional and bilateral initiatives. India, for example, has also received requests from about 50 countries to take commitments in a range of service sectors with regard to transparency in domestic regulations, simplification of procedures, elimination of differential treatment of foreign service suppliers and facilitation of the movement of natural persons. India has also made requests to trading partners to consider liberalization in computer related services, architecture services, health services, audio-visual services, tourism, maritime services and financial services.

Appropriate policy directions on services trade liberalization and regulation in a regional and bilateral agreement can only be arrived at if complete information on magnitude of services trade among trading partners is available, and these are digested, analyzed, and turned into policy-relevant conclusions. It is important to note here that the Organization for Economic Cooperation and Development (OECD) does provide such data for their member countries, and important lessons could be learnt from the experiences of OECD Asian economies, viz. Japan and Korea as other Asian countries approach this task. Indeed, the regional organizations such as Asean may consider providing such information to its members.

Third, more robust data needs to be generated by statistical organizations in Asia on services trade that occurs through Modes 3 and 4, viz. commercial presence through foreign direct investment (FDI) and movement of natural persons. Trade generated from FDI in the service sector is a reflection of the country's international competitiveness and facilitates in estimating the value addition of a particular country at different stages of production of a particular product.

The above would require developing data on Foreign Affiliates Trade in Services (FATS) to properly estimate the amount of services trade generated by foreign affiliates in a particular country, such as in the case of Intel's chip manufacturing and other R&D activities that are gathering pace in Asian economies, including India. Efforts are beginning to be taken in this direction by the Reserve Bank of India, which recently undertook a survey of computer service exporters in India to estimate the share of computer services trade in India by the four modes of supply.

Fourth, individual countries wherein existing potential of international competitiveness in the service sector is relatively more underestimated, viz. India should devote greater resources to developing more robust data on bilateral services trade and labor flows. The aim should be to make services trade data as accessible to researchers, businesses, and policymakers as merchandise trade data. Indian authorities and industry need to give high priority to developing bilateral service trade flow data base. This is particularly vital for the IT and ITES services, because the competitive advantage in them has been constantly shifting. Notably, National Association of Software & Services Companies (NASSCOM) estimates India's exports of IT and ITES services to reach US $ 60 billion by the year 2010.

Finally, in the context of efforts towards economic integration, there is a distinct need for industry specific groups in various service sector industries across Asia, to interact and collaborate with respective national statistical organizations to facilitate them to generate quality data on services trade. Policymakers may find a regional dialogue on different types of services useful for purposes of chalking out an appropriate integration strategy.

As the quality and coverage of data on remittances is still not robust, the World Bank and the IMF, in collaboration with the United Nations have launched an initiative to improve statistics on remittances (and migration). Among others, the agenda includes providing a practical definition of remittances for the collection of aggregate statistics; develop cost-effective data collection and estimation guidelines; preparing questionnaire modules for conducting household surveys of remittance senders and receivers. These steps are expected to improve the data quality, enabling better policy measures.

V
Concluding Remarks

The growing quantitative and qualitative importance of cross-border transactions in the services sector involving trade, investments, and remittances, needs to be more fully reflected in academic research, national and international policies and practices, and in business and corporate strategies.

The definitional and measurement issues concerning the services sector transactions are complex, and traditionally not given due attention by national and international agencies collecting such data. As a result, researchers have over-emphasized merchandise trade data to analyze production fragmentation, or mapping of different aspects of value chain. This has led them to drawing inappropriate and unwarranted conclusions and implications.

The OECD has devoted considerable intellectual and other resources to develop services database for their members. Among Asian countries, only Japan and Korea are OECD members. The other Asian countries, particularly China and India must devote greater national efforts to tracking the services sector. At a global level, WTO is best positioned to undertake this task. There is also a need for coordination between national and international efforts in developing robust and standardized database for services sector.

As importance of services sector grows, there is an increasing need to better understand the linkages between agriculture, manufacturing, and services. Indeed, services have become an essential, even critical aspect of agricultural and manufacturing activities. This suggests that developmental debate regarding the balance between these sectors needs to be much more nuanced than the simple notion of services versus manufacturing, or agriculture versus manufacturing, fashionable in some countries.

[i] The Indian Institute of Technology (Kharagpur) is in the process of signing an MOU with the National Chiao Tung University (NCTU) of Taiwan as part of a joint effort to facilitate exchange of research and train manpower in the area of chip design and fabrication (Business Standard, November 24, 2006).