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Uncovering Developing Countries' Performance in Trade in Services

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Services play a broad and strategic role in the economy. Trade in services has been expanding rapidly because technological improvements have reduced the cost of cross-border exchange from infinity to virtually zero, thereby allowing for new export activities. Trade in services, particularly business services, has become an element of export diversification for many developing countries. Besides traditional activities such as tourism, activities such as health and information and communication services are among the most successful services exports. This note focuses on the determinants of trade in services for developing countries.

International trade is no longer exclusively about goods crossing borders. Trade in services, particularly business services, has become a dynamic component of trade as well as an alternative for export diversification in developing countries. Increasing tradability allows the cross-border exchange of services, such as professional services, that previously required the close proximity of providers and consumers (Ghani 2009; Ghani and Kharas 2010). During 2000–2007, before the financial crisis, trade in services grew as fast as trade in goods, at an average rate of 12 percent annually. Over the same period, trade in business services (such as engineering, legal, health, accounting, and management services) grew even faster at 14 percent. During the crisis, trade in business services as well as investment programs in this sector proved to be more resilient than trade in goods, and investment prospects in this area remain strong (Borchet and Mattoo 2009; UNCTAD 2009).

Services play a broad and strategic role in the economy. Low-cost and high-quality services generate economywide benefits.

Empirical research concludes that welfare gains from services liberalization are substantial, resulting in a more efficient allocation of resources and contributing to economic growth. As inputs, services facilitate transactions through space (information technologies, communications, and logistics services) or time (financial services). Financial services, telecommunications, transportation and other services are key inputs for all production of goods and other services and thus are important determinants of economywide competitiveness (Hoekman and Mattoo 2008; Francois and Hoekman 2010).

Despite enormous challenges, developing countries are increasingly exporting services. Diverse patterns seem to emerge: Latin American countries have become exporters of services through investments abroad, while South Asian countries are stronger in cross-border services exports. In contrast to the determinants of trade in goods, much less is known about the factors that determine the participation of a developing country in trade in services and the types of policies that can help sup-

port export growth. International negotiations and agreements have a potential role to play in this connection, but there is still much to be learned on how best to take advantage of this instrument.

Services Exports from Developing Countries

A large number of developing countries have successfully exported services both within their own regions and to high-income countries. India's success is well known: exports of software and business process services account for approximately 33 percent of India's total exports. Brazil, Costa Rica, and Uruguay export professional and information technology-related services; Mexico exports communication and distribution services; and Chile exports distribution and transportation services.

African countries are also participating. Morocco, Tunisia, Kenya, and South Africa provide professional services to Europe, and Egypt has developed a world-class call center sector. The growing phenomenon of health tourism is an opportunity for many developing countries. Exports of health services are successfully provided by the Philippines, Thailand, and India, and countries in the Middle East and North Africa and in Latin America and the Caribbean.

Capital-intensive and managerially complex services are also part of the story. Construction services providers from developing countries are among the top 225 international contractors. Firms in developing countries engage in trade across a variety of environmental services segments. Some developing countries are also engaging in financial as well as telecommunication services (Cattaneo et al. 2010).

Divergent Patterns among Developing Regions

There are differences in trade patterns among developing regions. In South Asia, services exports are mainly concentrated in cross-border services, and within this mode, in information and communications technologies (ICTs), communication services, and ICT-enabling services (cross-border provision of business and professional services, among others). In East Asia, services exports are closely linked to manufacturing exports. This may provide opportunities in the future to diversify into new activities not linked to trade in goods for these countries. In Latin America, exports tend to be more concentrated on services that are supplied through direct investment in other countries in the region. For instance, 61 percent of Chile's investment abroad is in services and energy industries mainly in neighboring countries. Although Brazil's outward investment is much more diversified both in terms of sectors and markets, services play an important role. In financial, construction, and engineering services, Brazil has been a successful exporter via

investment abroad. Likewise, Mexico's outward direct investment is diversified in terms of sectors and countries, but services play an important role in telecommunications, distribution, call center activities, and offshoring. Although in Africa there is no clear trade pattern yet, services have been also emerging as an important trade topic.

The geographic patterns of trade also differ. The destination markets for services exports from South Asia are mainly developed countries. In contrast, in Latin America exports (measured by investments flows) are mostly to countries in the same region. Countries in the Middle East and North Africa region tend to export services to Europe, while South African services providers are increasingly targeting countries in Africa.

Domestic Policies and Trade Performance

What determines the participation of a developing country in trade in services?¹ Anecdotal evidence suggests that successful exporters often are very different in terms of openness to trade and foreign investment; tax incentives, such as special economic zones (Costa Rica and Uruguay); the business environment; and geographic location. Thus it is difficult to generalize. What is clear is that complementary policies need to support liberalization.

Although empirical evidence suggests that greater openness is associated with higher economic growth (Mattoo 2006), the correlation between export performance and liberalization in services seems to be weaker. Of course, this does not mean that liberalization should not be pursued, just that by itself it may not provide enough to drive services export performance. Liberalization does not create spontaneously entrepreneurial drive, improve the skills endowment, or mobilize the managerial capabilities required to export services. Complementary policies are required to ensure that investment in infrastructure and education will take place. It is important to identify possible market failures such as lack of information and transparency, and to ensure that appropriate regulatory regimes are in place. These are areas where the Aid for Trade Initiative can play a constructive role.²

Identifying the reasons for the successes of developing countries in exporting services and the reasons for their underperformance remains a challenge because of the lack of reliable data. Leaving aside the case of transportation and tourism sectors, available data suggest that countries with better human capital endowment tend to be ranked among the most important exporters of business services. Regressing aggregate services exports on the average years of tertiary schooling (obtained from Barro and Lee [2010]) yields a positive and significant coefficient after controlling for electronic infrastructure and institutional variables, such as contract enforcement. This implies that human capital is an important determinant of services exports (these results are replicated if a gravity regres-

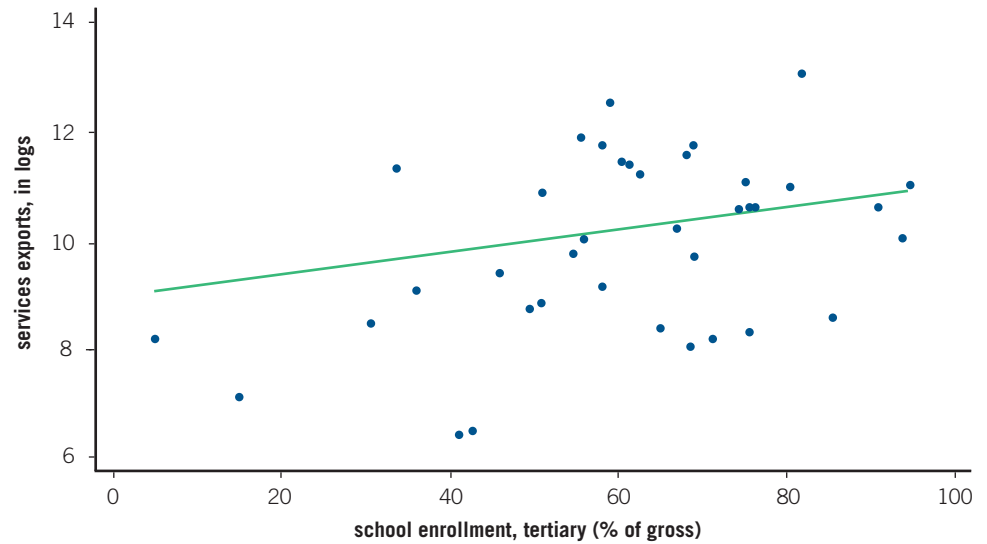
sion framework is used). The finding that human capital is critical to services exports holds true irrespective of the data set used, time period of study, or the estimation methodology. A partial correlation plot between tertiary education and services exports in figure 1 depicts this relationship.

Nyahoho (2010) assesses the importance of factor intensity as a determinant of trade in disaggregated services. Human capital is clearly related to exports of computer and information services. Other exports (such as construction services and public works, royalties and license fees, and computer and information services) are positively linked to research and development intensity.

Other variables, such as business environment and financial attractiveness, correlate less strongly with services performance. However, regression analysis suggests that factors such as contract enforcement or the rule of law are important determinants of services exports after controlling for Internet penetration. The explanatory power of institutional variables loses significance when controlled for higher education. Part of the explanation is that the most successful offshoring companies focus less on saving money and more on improving operational performance. These companies base their strategies “on building a global delivery model rather than offshoring per se. In other words, when planning for the future, top companies make decisions based on their entire enterprise, rather than simply choosing the next offshore destination” (A. T. Kearney 2007, 12). When we take institutional variables to bilateral services trade data, they do not appear to be critical. Instead, what matters more for bilateral services exports is the similarity in institutions rather than the absolute quality of institutions. This result is similar to Rose (2000), who found that countries with the same colonizers had similar institutions and therefore traded more.

Using a gravity model, Shingal (2010) analyzes various potential determinants of trade in services,

Figure 1. Human Capital and Services Exports

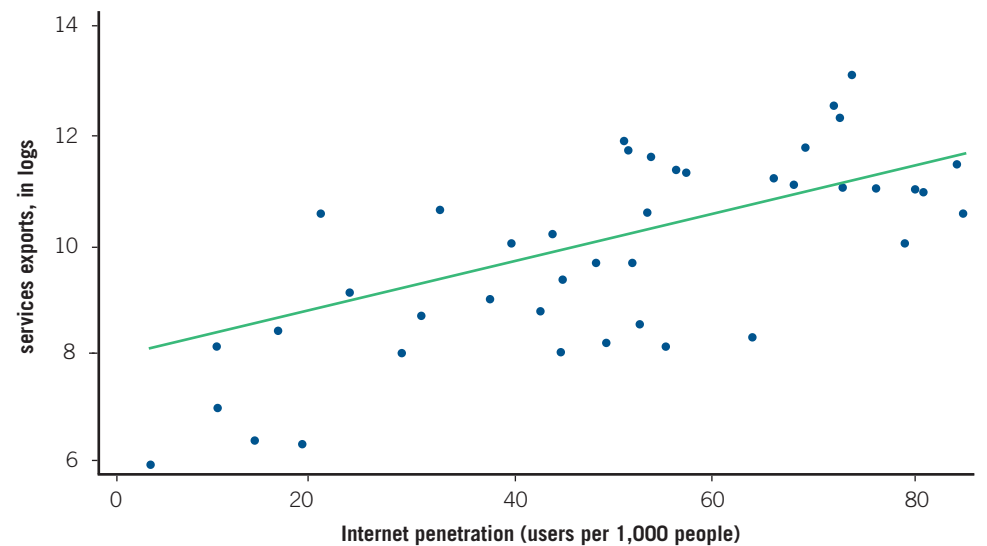


Source: World Development Indicators (2007).

including market size, trade in goods, the presence of an English-speaking workforce, quality of infrastructure, the openness of the trade policy regime toward the various modes of services delivery, cost of human capital, and common laws/legal systems. Shingal’s main findings are that human capital, teledensity, and trade restrictiveness variables have the biggest impact on bilateral services trade and thus should be the policy focus if the objective is to promote services trade.

Similar to a study on the services trade for the United States (Freund and Weinhold 2002), a cross-country regression analysis on services trade determinants also supports the view that Internet penetration is critical in altering the geography of ser-

Figure 2. Electronic Infrastructure and Services Exports



Source: World Development Indicators (2007).

vices provision. Figure 2 shows this positive relationship through a partial correlation plot between Internet users per 100 inhabitants and services exports.

In a bilateral trade framework, preliminary results suggest that what matters more in services exports is Internet penetration in the trading partner, as opposed to the exporter. What is required for exporting services is access to high-quality electronic infrastructure; this need not cover the general population of the exporter, explaining why Internet penetration among the general population may not significantly affect services exports. This suggests that developing country exporters may need to invest in equipment to ensure better quality telecommunications if the public network is inadequate, or alternatively, the government should attempt to create zones where the needed infrastructure inputs are supplied. An example of such zones are the software technology parks in India. On the other hand, to successfully export services, it is important that the consumers of services in the partner country have better access to good quality electronic infrastructure.

International Negotiations and Developing Countries

Trade agreements can play a complementary role in promoting both domestic reforms and opening markets for services exports, thereby contributing to countries' competitiveness and trade diversification strategies. But negotiations are resource intensive because they require deep knowledge of the sectoral policy issues involved and the ability to manage potential negative consequences of liberalization. Coherence between development strategies and policy reforms in the services sector is critical, yet difficult to achieve.

Because of the resource-intensive nature of services policy reforms and trade agreement negotiations, developing countries are confronted with three challenges: (i) improving their knowledge on regulatory experiences and the impacts of policy reforms undertaken in other countries; (ii) identifying alternative options/good practices; and (iii) understanding and managing the complex political economy of policy reform and trade negotiations.

Currently there is no forum or mechanism that is aimed at fostering a substantive, evidence-based discussion of the impacts of services sector policies, the appropriate design of sector-specific regulation, the preconditions for realizing welfare gains from liberalization, or how to address possible negative distributional consequences of policy reforms. Feketekuty (2010) and Hoekman and Mattoo (2010) have argued that such a forum could have a significant impact in creating the preconditions for trade agreements to be used as a strategic instrument by governments seeking to improve the performance of national services industries. The World Bank International Trade Department is exploring the creation of a "knowledge platform" that brings together high-income, emerging, and other developing countries. Many organizations have expertise

and experience that could contribute to a process of "learning to learn" from country experiences. There is also much to be learned from the experiences of emerging market economies. A services knowledge forum would help concentrate and disseminate knowledge that exists in research centers, international organizations, and academic institutions, as well as insights and experiences of policy makers, regulators, and private sector representatives, helping to stimulate fruitful dialogue, exchange of experiences, and learning about good regulatory practices.

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Notes

1. What follows draws on preliminary results of an ongoing work on the determinants of service exports.
2. Aid for Trade aims to help developing countries, particularly least-developed countries, develop the trade-related skills and infrastructure needed to implement and benefit from World Trade Organization agreements and to expand their trade (http://www.wto.org/english/tratop_e/devel_e/a4t_e/aid4trade_e.htm).

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