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Liberalizing international trade in services: Challenges and opportunities for developing countries

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KIELER DISKUSSIONSBEITRÄGE

412 KIEL DISCUSSION PAPERS

Liberalizing International Trade in Services: Challenges and Opportunities for Developing Countries

by Matthias Lücke and Dean Spinanger

CONTENTS

- Several developments in international trade in services impact strongly on developing countries: First, the world-wide diffusion of information technologies (IT) has created new export opportunities for developing countries in IT services. Second, the recently proclaimed Millennium Development Goals for poverty reduction can only be attained if key services are provided more efficiently in developing countries—particularly through the liberalization of service imports. Third, in the ongoing Doha Development Round (DR) of trade negotiations, developing countries are asked to formally commit to liberalizing their service imports under the terms of the General Agreement on Trade in Services (GATS).
- Developing countries will benefit from liberalizing service imports if liberalization enhances competition on the supply side. This is typically the case for producer services, such as domestic and international transport, financial services, and telecommunications. The lifting of restrictions on the market access by foreigners (including through direct investment) will often improve service quality or lower prices and thereby enhance the international competitiveness of downstream industries. In Doha Development Round negotiations, therefore, developing countries may find it useful to commit to liberalizing imports of producer services.
- By contrast, the benefits of import liberalization are less clear for some consumer services where supply is subject to network monopolies (e.g., water and energy distribution) or demand is constrained by poverty (health care, education). Here, achieving a socially optimal level of supply may require carefully calibrated government policies, possibly with international donor support. For developing countries, such sectors should not be priority areas for commitments on service imports under the GATS.
- Most service exports by developing countries, especially IT services transmitted electronically, face few import barriers in industrialized countries. However, under the GATS, service exports may also be delivered through temporary movement of natural persons, e.g., developing country nationals working in industrialized countries without becoming residents there. If Doha Development Round negotiations were to increase opportunities for such temporary labor migration, the benefits to developing countries could be huge.

Contents

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1 Introduction and Executive Summary

While some services, such as international transport and tourism, have been traded internationally without much fanfare for many decades, several recent developments have raised new concerns about how international trade in services impacts on developing countries. First, technological progress in information technology (IT) has sharply reduced the cost of the international transmission of information and has thereby rendered a large number of IT-related services internationally tradable. A few developing countries, most notably India, have benefited from this progress as their IT-related service exports increased markedly over the last decade. This raises the question of whether, and how, this pattern could be repeated elsewhere.

Second, the renewed focus on poverty reduction in international aid policy, epitomized by the Millenium Development Goals, has drawn attention to the role of those service sectors (e.g., water, electricity, health care, and telecommunications) that are crucial for improving living standards and for increasing the competitiveness of export industries in developing countries. Frequently these services used to be provided (if at all) by loss-making state enterprises at less than satisfactory quality. With support especially from the World Bank and other development banks, many developing countries have embarked on sectoral reforms that have frequently involved foreign investors when privatizing service suppliers and the setting-up of new regulatory bodies. The mixed outcomes of such reforms raise the question of what lessons should be learned from the experience and how policies for service sector liberalization and reductions in import barriers should be designed in the future.

Third, with the conclusion of the Uruguay Round of trade negotiations in April, 1994, the liberalization of service imports became institutionalized in the world trading system. While the Uruguay Round succeded mostly in establishing a conceptual and institutional framework for service sector negotiations, with little actual liberalization induced by the round itself (Table 1.1), analytical work since the late 1990s has demonstrated the large potential benefits of liberalizing market access for foreign service suppliers, especially in business services. This raises the question of how developing countries should position themselves in the ongoing Doha Round talks on services if and when these proceed to the stage of serious negotiations.

Table 1.1:
Overview of Computable General Equilibrium Assessments of the Uruguay Round[a]: Distribution of Welfare Effects by Specified Disaggregation (Percent)

Study[b]	Model[c]	Agriculture	Primary	MFA	Manufact.	Services	Tariffs
1.		5		14			81
2.	I[d]	68		15	18		
	II[e]	38		12	49		
	III[f]	61		17	23		
3.	I[g]	9	3	35	53		
	II[h]	3	6	61	30		
	III[h]	3	7	50	39		
4.	I[g]	31		39			30
	II[h]	10		64			26
5.	I	46		29			24
	II	26		37			37
6.		34		40		14	12

[a]Drawn from Francois et al. (1996, Table 1, last column); please see original for specifics. — [b]Study: 1 = Hertel et al. (1995); 2 = Harrison et al. (1995); 3 = Francois et al. (1995); 4 = Francois et al. (1994); 5 = Yang (1994); 6 = Nguyen et al. (1993). — [c]The Roman numerals designate model runs carried out under differing assumptions; the reader is advised to refer to the original tables in the articles to examine in depth the structure and the underlying assumptions. — [d]Static. — [e]Dynamic. — [f]Static; not perfect competition (PC). — [g]Steady state. — [h]Steady state, no PC.

These three core questions, while broadly interconnected, relate to analytically separate issues—technological, economic, institutional, and political; service imports vs. exports (each under different modes of supply); multilateral, bilateral and unilateral policies. These diverse analytical issues reflect the fact that services constitute a large, heterogeneous sector and that priority policy concerns are therefore highly subsector- and country-specific. At the same time, there are overriding basic factors which shape the efficiency of service sector liberalization and thus will need to be taken into consideration.

This report provides a broad overview of the key policy issues faced by developing countries and suggests how national governments and other actors may proceed to resolve them. Since developing countries constitute a broad and diverse group, the issues emphasized by this report—related broadly to low per capita income or to limited administrative capacity—affect individual developing countries to different degrees, depending on their size and level of economic development. The discussion is structured around the concerns raised by WTO negotiations on services; nevertheless, the main conclusions regarding service sector reform and import liberalization apply irrespective of how the current impasse in Doha Round negotiations is resolved.

Following this introduction and executive summary, Chapter 2 deals with several institutional and policy issues raised by the General Agreement on Trade in Services (GATS). First, some provisions in the GATS are unclear and lead to uncertainty with respect to the interpretation of commitments, such as the definition of public services, which are not covered by the GATS (Art. I(3)). We suggest that developing country negotiatiors should always assume the widest possible reading of these provisions and specify their commitments and exemptions accordingly.

Second, it has been suggested that, rather than having to go through complex multilateral negotiations under the GATS, developing countries would be better off if they liberalize service imports unilaterally. We point out that developing countries will indeed be the greatest beneficiaries of liberalizing their own imports; hence unilateral liberalization would be entirely appropriate. At the same time, political economy arguments suggest that some reforms might not be politically feasible when undertaken unilaterally because of opposition from interest groups; however, when the same reforms are part of a package of multilateral liberalization that also benefits the country's potentially new exporters, then the interest groups supporting liberalization would be strengthened and liberalization might become politically feasible.

Third, it has been asked how developing countries will fare under the proposed request-offer format for service negotiations, given its emphasis on bilateral negotiations in which developing country negotiators would frequently face their counterparts from much larger trading partners. We argue that while the request-offer approach has its drawbacks, it is difficult to conceive of a different format for negotiations that would adequately correspond to the complexity of the task. However, we suggest that developing countries should aim to negotiate jointly with countries with which they share a common trade policy agenda; furthermore, during an advanced stage of negotiations, there may be room for negotiating formula-type approaches to liberalization so that commitments would be easier to compare across countries.

Chapter 3 takes up the debate on how, and by whom, international trade in services should be assessed with reference to the objectives of the GATS and particularly the role of developing countries. We argue that the broad mandate of GATS Art. XIX(3) provides no useful operational guidance. What is needed, rather, are highly country- and sector-specific assessments that can inform decision-makers on countries' negotiating positions. Such analyses will involve a wide range of contributors from governments, civil society, academia, and international organizations. There is no need for a grand, "once-and-for-all" assessment by the Council for Trade in Services on which all members would have to agree. Governments will naturally tend to draw different conclusions from whatever empirical evidence they are presented with; appropriately, the GATS leaves its individual members considerable freedom to decide how far they wish to push import liberalization.

Chapter 4 looks briefly at the impact of service sector liberalization since the end of the Uruguay Round and notes that it received but little attention early on, largely because little actual liberalization was achieved at the time. Methodological papers on the measurement of trade barriers have shown increasing sophistication in recent years. While the data requirements for the more involved approaches are considerable, their results do allow for a better understanding of the fine points of the liberalization process. Based on a fairly wide range of methodologies and sectors studied, it seems clear that import barriers for services are typically higher than for goods, and also higher in developing than in high-income countries. This implies, of course, that developing countries have more to gain from service sector liberalization. And where they need to invest their efforts is accordingly examined, and an approach to be used for investigating specific countries and sectors is suggested.

Chapter 5 reviews empirical studies on income and welfare gains from a prospective liberalization of service imports, either comprehensive or sectoral. The income estimates for comprehensive liberalization based on computable general equilibrium (CGE) simulation models are typically larger than for eliminating the relatively few remaining barriers for goods trade, but are not spectacularly large (typically, around 2 percent of GDP for a developing country with significant initial import barriers in services). The gains tend to be much higher when additional inflows of foreign direct investment (FDI) are included in the simulations. Sector studies confirm that restructuring and import liberalization tend to improve sector performance and tend to be associated with higher GDP growth overall. Overall, however, the potential benefits from import liberalization are highly country-specific so that sectoral priorities for liberalization need to be established on a country-by-country basis.

Chapter 6 is a case study on financial sector reform, focusing on the impact of liberalizing market entry by foreign banks. We emphasize that foreign bank entry does not necessarily entail capital account liberalization, which is not covered by the GATS and whose costs and benefits may not be straightforward for many developing countries. An extensive literature demonstrates that, in a wide variety of countries, foreign bank entry had a positive impact on (i) competition and efficiency in banking; (ii) banking sector stability; and (iii) the allocation of credit across sectors of the economy. Looking at individual country experiences, we use the case of Vietnam to illustrate the issues raised by allowing foreign bank entry (under the U.S.-Vietnamese Bilateral Trade Agreement) when the banking system is weak and suffers from severe financial repression. Drawing on the experiences of several other developing countries that liberalized their financial sectors from a similarly weak position, we conclude that Vietnam's domestic banks should be able not only to survive more intense foreign competition but may even be strengthened by it. We also note that a positive outcome depends on complementary reforms introducing prudential regulations and banking supervision and of dealing with the large stock of nonperforming bank loans of state enterprises.

In Chapter 7, we turn to the prospects for developing countries service exports. We focus on Modes 1 and 2 (cross-border supply and consumption abroad) and Mode 4 (temporary presence of natural persons) because service-sector FDI originating in developing countries (Mode 3 exports) is still small. For all developing countries combined, Mode 1 and 2 exports have grown less rapidly than exports of goods since 1995. Studying the example of India, whose nontraditional service exports have increased impressively, we find several factors (including plenty of well-trained university graduates with good English and low wage expectations) that do not exist in many other developing countries and therefore make it unlikely that India's success in IT-related service exports will be replicated elsewhere.

Compared to all other trade flows, larger service exports under Mode 4 (temporary presence of natural persons) promise huge welfare gains to developing countries. Here, unfortunately, high-income countries maintain rather tough entry restrictions, motivated in large part by the likely adverse distributional effects of all forms of immigration. While the GATS does not provide a blueprint for liberalization in this area, even relatively small movements of workers would produce large welfare gains for the workers and their home countries.

Chapter 8 draws together the policy implications from the analysis. With respect to ongoing service negotiations, developing countries should enter talks with a clear idea of which liberalization steps they wish to focus on. They should not be overly impressed by the requests for commitments by the EU Commission, which respresent a wish list more than anything else. With respect to implications for technical and other donor assistance, we argue that an enhanced policy dialog with developing country governments about service sector reform and import liberalization could be helpful to promote internal debate in developing countries. Closer to the implementation of reforms, grants and loans may be used to support comprehensive sectoral reform programs, including the establishment of appropriate regulatory agencies. In particular, regulatory cooperation among developing countries may be encouraged at a bilateral or regional level as some countries may be too small to support full-fledged regulatory agencies on their own. Finally, export promotion may be justified economically if the cost of market entry is initially high but falls as exporters gain experience.

2 Developing Countries in GATS Negotiations

Not least because trade in services was only recently included in the multilateral trading system and little experience exists with the implementation of the GATS, various technical and procedural questions need to be answered satisfactorily to ensure that developing countries benefit from the liberalization of trade in services. This section discusses three broad issues that have a bearing on the subsequent analysis of the benefits and costs of services liberalization in developing countries and the guidelines for effective regulation: the sectoral coverage of the GATS (Section 2.1); the relationship between unilateral import liberalization and multilateral liberalization under the GATS (Section 2.2); and the choice of negotiating procedures that enable developing countries to articulate their interests while they simultaneously benefit from special and differential treatment as appropriate (Section 2.3).

2.1 The Scope of the GATS

The broad scope of the GATS, combined with the complexity of many rules and the fact that commitments, once made, are difficult to reverse, has raised concerns about the continuing ability of member countries to pursue public policy objectives through domestic regulations or by providing public services (e.g., Woodroffe 2002).[1] These concerns are particularly acute for developing countries with limited administrative capacity and financial means to pay for legal representation, for example, in the WTO's Dispute Settlement Mechanism. The essence of these concerns is that, because of the rules' complexity, sometimes unclear wording, and uncertain interpretation by future dispute settlement panels, a commitment today may have unintended effects in the future or may tie the hands of future governments in politically unacceptable ways. This section explains the concerns and discusses developing countries' options for dealing with these issues.

To put the concerns into perspective, it is helpful to recall how GATS members enter into commitments regarding the application of GATS disciplines. In principle, such GATS disciplines as most-fa-

[1] The procedure for withdrawing commitments is laid down in GATS Art. XXI. In essence, trading partners affected by the withdrawal may insist on compensatory adjustments in the member's schedule; without their agreement or equivalent arbitration, the commitment cannot be withdrawn. This makes the process cumbersome and unpredictable. For trade in services, this procedure has hardly been used so far. One current case is related to the eastern enlargement of the European Union; some new EU members are now obliged to adopt a less liberal import regime than they committed to when they joined the WTO. Hoda (2001: Chapter IV) discusses in detail the use of the equivalent procedure for trade in goods (Art. XXVIII of GATT (1994)) since 1948.

vored nation (MFN) or national treatment or market access provisions may apply to any service supplied commercially as well as to certain domestic regulations that could potentially act as trade barriers. However, GATS members have wide latitude in subjecting or not subjecting their service sectors to those disciplines. While the general obligations ("horizontal commitments") under Part II of the GATS (such as MFN treatment) apply to all commercially supplied services, members may nevertheless register exemptions from MFN treatment.[2] Specific ("vertical") commitments under Part III of the GATS, which include market access provisions and national treatment and have a much larger potential economic and policy impact, apply only to those service sectors to which each member explicitly subscribes (bottom-up or positive list approach). In principle, therefore, GATS members remain in full control of their policies, provided that they have registered all desired exemptions from general (horizontal) obligations in their country schedules at the time of the Uruguay Round and ensure that their specific (vertical) commitments (Part III) fully cover their policy preferences. At the same time, the administrative hurdles for reversing a commitment under GATS Art. XXI are considerable (even if it was made inadvertently).

The concern about WTO members' ability to pursue public policy objectives stems from the complex nature of certain GATS rules combined with some unclear legal language, including the definition of the services covered by the GATS (Art. I(3)) and the distinction between market access and domestic regulations (Low and Mattoo 2000).[3] Art. I(3) defines the services covered by the GATS to include "any service in any sector except services supplied in the exercise of governmental authority," where "'a service supplied in the exercise of governmental authority' means any service which is supplied neither on a commercial basis, nor in competition with one or more service suppliers." This definition lacks clarity and there is little guidance available on how future dispute settlement panels may interpret it (in particular, there is no relevant precedence). For example, negotiators may conceivably overlook the need to state clearly that certain commitments for broadly defined service sectors do not apply to 'governmental' subsectors, such as public broadcasting in the case of audiovisual services. It is worth noting, nevertheless, that the wording of Art. I(3) leaves it up to each WTO member to decide whether a particular service is to be supplied under governmental authority, and hence not covered by the GATS. In particular, 'governmental' status would not be affected by the fact that, elsewhere, the same service is supplied commercially or by competing suppliers.

Similarly, the wording of the negotiating mandate of Art. VI(4) of the GATS regarding future disciplines on domestic regulations is somewhat vague, and the article is therefore quoted in full: "With a view to ensuring that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services, the Council for Trade in Services shall, through appropriate bodies it may establish, develop any necessary disciplines. Such disciplines shall aim to ensure that such requirements are, inter alia: (a) based on objective and transparent criteria, such as competence and the ability to supply the service; (b) not more burdensome than necessary to ensure the quality of the service; (c) in the case of licensing procedures, not in themselves a restriction on the supply of the service."

Thus future disciplines will need to spell out whether requirements (a), (b), and (c) should apply irrespective of whether a member has made specific commitment on a given sector, as a literal reading of Art. VI(4) suggests; or only in the presence of a specific commitment which, naturally, should not

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[2] Exemptions from most-favored nation treatment are supposed to be temporary, but in practice do not carry an enforceable time limit (GATS Annex on Article II Exemptions).

[3] Unintended consequences of undertakings may be nontrivial, as the U.S.–EU dispute during the late 1990s over the EU's proposed banana import regime demonstrates. The proposed import regime, whose main purpose was to protect small-scale Caribbean banana producers linked with the EU under the Lomé Convention, implicitly discriminated against U.S.-owned wholesalers in violation of MFN treatment and was therefore ruled illegal by successive dispute settlement panels. The fact that even the EU's well-paid and well-trained negotiators had failed to notify an appropriate exemption during the Uruguay Round makes the negotiating tasks faced by small or poor developing countries with limited administrative capacity appear rather demanding.

be undermined by domestic regulations, as logic suggests. So far, the Council for Trade in Services, through its Working Party on Domestic Regulation, has made little progress developing these disciplines; the only draft disciplines available that may convey a sense of possible outcomes are for the accountancy sector. These would only apply to those countries that have made specific commitments for the sector.[4]

Regarding the positions for developing countries to take in future negotiations, this discussion suggests the following:

- Whenever feasible, negotiators should work toward clarifying unclear language in the GATS. Specifically, public services in line with Art. I(3) should be defined more operationally and precisely, and disciplines on domestic regulation (Art. VI(4)) should apply only if specific commitments might otherwise be undermined. At an operational level, such clarifications can best be achieved through the Council for Trade in Services.[5]
- Regarding thefuture disciplines for domestic regulations (Art. VI(4)), developing countries may want these to be kept as simple as possible, given limited administrative capacity. By contrast, industrial countries might seek rather detailed disciplines which would be easier to enforce, while being less concerned about administrative burdens.
- Negotiators should assume the widest possible reading of existing GATS rules and ensure that specific commitments are appropriately circumscribed.

Donors can help developing countries deal with the complexity of the GATS by providing training for developing country negotiators and related expertise.

2.2 Unilateral vs. Multilateral Liberalization of Developing Country Service Imports

If a country decides to open domestic service sectors to foreign competition, it does not follow that the GATS is always the most useful framework to do so; liberalization could also be undertaken unilaterally or, in many instances, as part of the conditionality for World Bank or IMF structural adjustment loans. Thus the country would benefit from a more liberal import regime without the delays, administrative cost, and potential risks involved in working through the GATS. Unilateral liberalization without commitments that are difficult to reverse may appear especially attractive to small or poor developing countries with limited administrative capacity, or when the technology of service supply is still evolving or best practices for regulation have not been firmly established. Against this background, this section discusses the pros and cons of developing countries actively engaging in the GATS process.

In principle, the rationale for a multilateral agreement on the liberalization of trade in services is the same as for trade in goods (Krugman 1997; OECD 2002). Unfortunately, this rationale can be obscured by the mercantilist language often used in international trade negotiations, which assumes implicitly that exports are desirable whereas imports are undesirable. Accordingly, a country offers "concessions" in the form of reduced import barriers (leading to higher imports), in return for reductions in import barriers by its trading partners (leading to higher exports). This language is grossly misleading because empirical studies show consistently that the benefits of trade liberalization accrue first and foremost to the liberalizing country itself: through lower prices, more varieties of consumer goods or services or industrial inputs, and more efficient resource use. While exporters also benefit by being

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[4] Draft guidelines may be accessed through: http://www.wto.org/english/tratop_e/serv_e/accountancy_e/accountancy_e.htm

[5] Technically, the General Council rather than the Council for Trade in Services conducts the functions of the Ministerial Conference in between its meetings (Art. IV, WTO Agreement) and is therefore responsible for interpreting the agreements (Art. IX(2), WTO Agreement). However, the General Council will normally follow a recommendation by the Council for Trade in Services as the membership of the two bodies is identical.

able to specialize more intensively according to their comparative advantages, their income gains are typically smaller than those of the import-liberalizing country.

Why then should developing countries not just liberalize unilaterally? Essentially, because unilateral liberalization may not be politically feasible. Existing protection provides benefits to small, well-organized groups (the producers of the protected goods or services), while liberalization would provide larger total benefits to much larger, less well organized groups (e.g., consumers or industrial customers). For each member of those large groups, the cost of protection is too small to spend sufficient resources on opposing it.[6]

Multilateral negotiations offer a way out of this dilemma by producing a package of measures that include improved market access for each country's exporters. Hence the protection lobbies now face more focused opposition by exporters, and the full package of welfare-improving liberalization measures may now become politically feasible. An economically sound justification of multilateral trade agreements, including for service imports, may thus be based on the political economy of trade protection, rather than on the benefits and costs of trade liberalization to the economy and society (which could, in principle, be obtained through unilateral instead of multilateral liberalization).

This logic also helps understand the extension of the multilateral trading system during the Uruguay Round in the mid-1990s from trade in goods (GATT 1947) to include services (GATS) and trade-related intellectual property rights (TRIPS). Further liberalization of trade in goods, which would benefit developing country exporters, involved politically difficult steps for high-income countries, such as bringing agriculture and textiles back into the mainstream of the multilateral trading order. By including services and TRIPS in the WTO system, it was possible for high-income country governments to gain the support of key export interests, especially in the United States, and ultimately implement the whole Uruguay Round package. In this sense, the GATS is a response to the growing tradability of services and their increasing share in global value added. Without liberalization that benefits service exporters in high-income countries (as well as, of course, service importers), it may no longer be possible to draw up a package of measures that would be politically acceptable to high-income country governments.[7]

Another motivation for liberalizing service imports in a multilateral framework, for example by making appropriate specific commitments, may lie in the enhanced credibility afforded by specific commitments under the GATS. Since such commitments are more costly and difficult to reverse than mere national legislation, policy reversals may be perceived as becoming less likely. In the particular case of service imports, however, developing countries may have alternative commitment devices available in the form of conditionality under loans from international financial institutions (IFIs). In particular, service sector reforms are often facilitated by project loans from the development banks, in which case appropriate sectoral policies, including guarantees for foreign direct investors, are typically part of the loans' conditionality.

What does this discussion imply for developing countries?

- They should liberalize service imports because, and as long as, this is advantageous for their economies.[8] Like every other country, they should liberalize primarily for their own benefit, not for someone else's.

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[6] Acting unilaterally, a large country might also be tempted to pursue an "optimum tariff" policy by which it would effectively use its market power to manipulate the terms of trade in its favor. When pursued by several actors, such optimum tariff policies would become self-defeating; the multilateral trading system helps governments avoid being drawn into spiraling protectionism (Bagwell and Staiger 2002).

[7] If there is any lesson from the failure of the Cancun Ministerial, it would seem to be this one. Developing countries as a group are now too important trading partners for multilateral negotiations to move forward without their active participation in liberalization, including in areas of export interest to high-income countries

[8] See Chapter 5 below for a discussion of potential benefits of service import liberalization, distinguishing inter alia between service sectors.

- Unilateral liberalization should be pursued if it is politically feasible. There would be no point in waiting for the outcome of multilateral negotiations if a particular measure is advantageous and can be implemented through the domestic political process, in spite of possible opposition from special interests. Furthermore, liberalizing countries may seek credit (i.e., additional market access) from trading partners for "autonomous" (i.e., unilateral) liberalization under the "Modalities for the Treatment of Autonomous Liberalization" issued by the Council for Trade in Services on March 6, 2003, without initially having to bind the newly liberalized regulations.[9]
- However, it may be possible to achieve more comprehensive import liberalization, over domestic opposition from special interests, as part of a multilaterally agreed, cross-sector liberalization package that includes measures of interest to a country's exporters (such as cuts in agricultural protection or textile tariffs). Therefore, it makes sense, in principle, for developing countries to remain involved in multilateral negotiations on service liberalizations, subject to the various caveats made in this paper.
- As a signaling and commitment device to increase the credibility of import liberalization, commitments under the GATS may be less important for many developing countries than IFI conditionality (either for project loans for the sector concerned, or for World Bank or IMF structural adjustment loans).

2.3 Negotiating Procedures

Negotiations on services during the Doha Round use the "request and offer" method, with extensive bilateral negotiations whose results would ultimately become multilaterally applicable through the most-favored nation provision (WTO Document S/L/93 of 29 March 2001). This section addresses concerns about whether the interests of developing countries are safeguarded under this approach, particularly as they face major players such as the EU and the U.S. in their bilateral talks.

The request-offer approach ideally involves each participant sending out a request to every other participant, asking the trading partner to undertake certain commitments to liberalize its imports. Each country responds to the received requests with an offer in the form of a draft schedule of commitments (WTO 2002; OECD 2003a). Since the draft schedule will normally fall short of the combined wish list received from trading partners, there would follow an iterative process involving bilateral, plurilateral, and, at some point, multilateral consultation. Ultimately, this process is expected to yield a draft schedule of commitments for each country that is acceptable to all other participants, given the overall outcome of negotiations in all areas covered by the trade round. Accordingly, draft schedules for services could potentially differ widely across participants, depending on their policy preferences, capacity to cope with adjustment costs (i.e., their level of development), etc. (Maurin 2003).

This procedure ensures, on the one hand, that the "bottom up" approach is followed in liberalizing trade in services (which is why it was strongly favored by some large developing countries including India). On the other hand, this procedure raises the question of how a degree of dynamism for substantive liberalization can be created in this framework, or even how a meaningful outcome can be reached at all. First, the very different sizes and trade volumes of participants lead to lop-sided bilateral negotiations. For example, it is difficult to imagine the EU or the U.S. making a major "concession" (see Section 2.2 on this use of language) in response to a request from a small developing country. Likewise, it is difficult to see what such "lop-sided" bilateral talks can accomplish beyond conveying an initial understanding of each side's concerns. Second, if national schedules differ widely, it will be difficult to establish the implicit reciprocity that is the core of any negotiation. Without some

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[9] The Modalities are available at: http://www.wto.org/english/news_e/pres03_e/pr335_e.htm. The Modalities are as yet untested; it is therefore impossible to predict how much additional market access unilateral liberalizers can secure for their exports in this manner.

form of yardstick, it will even be difficult to establish whether there has been significant liberalization at all.[10]

These observations suggest that the bilateral request-offer process should be complemented, at an early point during the negotiations, with a formula-based approach of some sort. The obvious difficulty with devising appropriate formulas is that trade barriers in services take many different forms (compared to trade in goods where there are only a few types of barriers which, moreover, lend themselves to quantification; Thompson 2000; see also Chapter 4). Hence, the "formulas" for service liberalization will tend to be qualitative rather than quantitative, such as "undertake named specific commitments in a named sector," "abolish substantially all MFN exemptions based on reciprocity," "make named commitments on Mode 4," "adopt reference paper on basic telecommunications," etc. Unless such formulas are highly sector-specific (and hence in potential conflict with the "bottom up" approach), they are likely to be less specific and, hence, verifiable than, say, a decision to tariffy nontariff barriers on agricultural imports or to cut average import tariffs on manufactures by a certain percentage. Different levels of development, policy preferences, etc. would still have to be taken into account. Nevertheless, such formulas would help to harness negotiating synergies among smaller and weaker participants, facilitate the setting up of individual country schedules while providing an element of comparability across members, and provide useful yardsticks against which commitments by each country could be measured. As a way of increasing transparency, formula approaches could also involve adopting particular scheduling techniques as proposed in the model schedules on maritime transport or basic telecommunications. By their very nature, formulas would be best discussed in a multilateral setting, presumably on the basis of position papers by key players or groups of countries.

In considering the position of developing countries under the request-offer procedure, it is useful to review possible alternatives. In the past, important trade negotiations took place mostly bilaterally among the key players. While developing countries benefited from the outcome through the MFN clause, their specific concerns did not feature. Since the failed Seattle Ministerial in 1999, there appears to be a consensus that the interests of developing countries should have a larger weight, particularly in the present, "Development" round of negotiations. It was this shift in emphasis, combined with the GATS emphasis on adapting liberalization to each country's particular conditions, that led to the present request-offer process. The flip side of this coin is that without substantive liberalization on their part, developing countries are unlikely to obtain significant "concessions" (this use of language is discussed in Section 2.2) from developed countries, be it on services or in any other area. On balance, it is difficult to see how progress could be made in negotiations other than through bilateral consultations that lead on to more structured negotiations in a plurilateral or multilateral setting.

What follows from this discussion for the position of developing countries in negotiations?

- Once again, it is essential that developing countries enter negotiations with a clear view of their own priorities for liberalizing their own service imports, in order to improve their own economic welfare (Hoekman 2000; Hoekman and Messerlin 2000). Developing countries' offers should reflect their strategies; negotiators should not be overly impressed by the wish lists/requests that they may receive from the major players in the negotiations, including the EU and U.S..
- While bilateral discussions with key players on their requests or offers are certainly helpful for understanding their priorities, small trading partners such as developing countries are well-advised to join forces with countries with similar underlying strategies to gain weight in sthe negotiations, working toward "formulas" that can be pursued in more advanced multilateral discussions. Negotiators ultimately face an inevitable trade-off between highly country-specific liberalization measures, which fully take national sensitivities into account, and the logic of multilateral liberalization, which calls for multiple parties to simultaneously liberalize in a verifiable and broadly similar manner (though not necessarily to a uniform level of market access and national treatment).

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[10] This problem is exacerbated by the fact that data on international trade in services are less reliable and substantive than for trade in goods and that the impact of trade barriers is much more difficult to quantify (see Chapter 4).

3 Assessing the Benefits and Costs of Service Liberalization for Developing Countries: Institutional and Methodological Issues

An assessment of the potential benefits and costs of trade liberalization in services is not only a precondition for individual countries to be able to formulate negotiating strategies (see Chapter 2). Art. XIX(3) of the GATS also calls on the Council for Trade in Services to "carry out an assessment of trade in services in overall terms and on a sectoral basis" with reference to GATS objectives in general and the increasing participation of developing countries in particular (Art. IV(1)) "for the purpose of" establishing negotiating guidelines and procedures. In 2001, the Council for Trade in Services issued negotiating guidelines (WTO Document S/L/93) without having undertaken a comprehensive assessment. Therefore, some NGO observers, including many opposed to trade liberalization in principle, have called for negotiations on services to be halted until after a full assessment. It has also been suggested that an "independent organization" should undertake this assessment, rather than the WTO (e.g., Woodroffe 2002).

There is no basis for either demand in the GATS. GATS Art. IV(1) explicitly assigns responsibility for the assessment to the Council for Trade in Services. Furthermore, membership of the Council for Trade in Services is open to representatives from all WTO members; in fact, a large number of developing country members actively participate in its proceedings. Council members obviously felt that they had all the information on the effects of liberalization that they needed for the limited purpose of issuing negotiating guidelines. Since negotiating guidelines are about procedure rather than substance (see Section 2.3 above), it is difficult to see why these guidelines would require modification in light of any conceivable outcome of a "full and comprehensive assessment."

There remain, at the same time, important methodological issues related to assessing the benefits and costs of trade liberalization in services that affect governments formulating their negotiating positions. These include (i) how to account for noneconomic costs of liberalization; (ii) how to weigh distributional effects against aggregate welfare gains; (iii) how to make sense of the wide range of empirical estimates of economic benefits of liberalization; and (iv) in light of the above, how assessments of the effects of trade liberalization in services and future research should be organized.

First, much concern has been voiced about how liberalization of certain services may affect noneconomic policy objectives. For example, in education, the print media, or audiovisual services, domestic or regional production or control over production may be viewed as a desirable expression of a country's cultural identity. Such noneconomic benefits are not amenable to the methods of economic analysis discussed below. However, within the GATS negotiating framework, it is straightforward to think of them as part of a country's political preferences. As discussed in Chapter 2, the GATS leaves countries free to maintain exemptions from horizontal commitments (such as MFN treatment) or not to make specific commitments for a particular sector in order to protect noneconomic political objectives. Clearly, this may not be costless; countries forego an economic welfare gain (for example, greater availability or lower prices of imported audiovisual material) by maintaining restrictions. However, it is up to national policy-makers to decide whether the noneconomic benefits of such restrictions are worth their economic cost.

Second, the liberalization of international trade in certain services may negatively impact on poor people's access to those services, particularly when the policy regime for a sector is simultaneously reformed and implicit or explicit subsidies are eliminated. This issue has frequently been encountered in the privatization of public utilities such as water or energy distribution when retail prices were raised to cover long-run marginal costs and pay for improvements in service quality (such as the elimination of periodic electricity blackouts). One key observation here is that the issue arises not so much because of international trade in services (typically, through new FDI in the particular sector) but because of the elimination of subsidies and the introduction of a new domestic policy regime. The effects

on the poor depend less on whether the privatized utility is domestically or foreign-owned than on the new regulation of the sector, especially whether more targeted forms of support for the poor replace price subsidies. In any event, the GATS does not prescribe particular modes of organizing essential services, including whether services are provided by the government (in which case they are outside the purview of the GATS) or commercially or by competing suppliers (in which case they are covered by the GATS; see Section 2.1). This leaves national policy-makers free to weigh the costs of alternative schemes to protect the poor against the benefits in terms of reduced poverty, without their choices being limited by the GATS.

Third, estimates of the income effects of liberalization from existing studies vary considerably. It is therefore important to understand the strengths and weaknesses of the research methods employed. While Chapters 4 and 5 below deal with some aspects of this discussion in detail, it is useful at this stage to summarize several robust findings and their implications for developing countries:

- The benefits from liberalizing service imports depend crucially on whether competition is effectively enhanced. Simply replacing a public monopoly with a private monopoly (for example, in the case of a network-based utility) will not necessarily make much difference in terms of the price and quality of the services provided (although a private investor may be able to undertake investments that a credit-constrained government cannot afford). Therefore, in the GATS context at least, network monopolies are not priority areas for developing country governments to enter into commitments.[11]
- Protecting the access by the poor to essential services involves regulatory issues that are not straightforward (see World Bank 2003 for a very useful survey and detailed analysis). It is conceivable that liberalization and privatization have sometimes occurred under time pressure (for example, because the fiscal cost of an existing arrangement had become unsustainable) and therefore in a less than fully planned fashion, including in the context of World Bank or IMF conditionality. Indeed, when the existing policy regime is no longer fiscally sustainable, reforms following a trial and error pattern may be the only way forward. However, it would be premature, in such an environment, to tie down the evolving policy framework through commitments under the GATS. Commitments would need to be based on a thorough understanding of the regulatory and distributional issues involved in sectoral reform as well as the way in which the (sometimes unclear) provisions of the GATS limit future policy choices if a commitment were made (see Section 2.1).
- Empirically based simulation (computable general equilibrium) models show consistently that the liberalizing country itself is the greatest beneficiary of its own (well-targeted) reforms. Furthermore, barriers to imports of services, especially producer services, are substantially higher than barriers to merchandise imports in all countries, and tend to be even higher in developing countries than elsewhere.[12] Therefore, developing countries can expect to reap fairly large income gains from comprehensive liberalization of trade in services, even without major changes in developed country barriers (OECD 2003b).
- One driving force behind the relatively large income gains from trade liberalization, especially in a dynamic perspective, is additional foreign direct investment in response to liberalized service imports. Clearly, however, FDI depends on more than the policy environment for a particular service sector. Countries will only reap the benefits of liberalization if their overall investment climate is sufficiently attractive for international investors (see, for example, Nunnenkamp and Spatz 2003).

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[11] The telecommunications industry is an important exemption because the monopoly status of land lines is eroded by alternative technologies (e.g., mobile phones) and because the sector involves several separate markets with their own technological characteristics (e.g., local vs. international calls).

[12] If producer services are more highly protected than downstream industries (i.e., their customers), protection of producer services becomes an effective tax on downstream industries. In practice, this will tend to hurt the international competitiveness precisely of those manufacturing industries in which developing countries tend to enjoy a comparative advantage.

- A recent sector-by-sector survey of developing country service exports under Modes 1 and 2 (cross-border supply and consumption by nonresidents in developing countries) reveals a significant potential for expansion (OECD 2003b). However, the income gains from higher exports under those modes pale in comparison to the gains from a more liberal regime in high-income countries for temporary stays of natural persons from developing countries (Mode 4), as long as "temporary" stays are not defined too narrowly. Although progress will be politically difficult to achieve, this is clearly one area where existing restrictions in high-income countries represent the main bottleneck preventing higher service exports by developing countries.

Fourth, given these indications of the state of knowledge on the effects of liberalized trade in services, how should the assessment of the effects of liberalization proceed? Well-targeted import liberalization by developing countries clearly holds out the prospect of substantial income gains. Apart from crucial methodological refinements (e.g., the measurement of trade barriers in service sectors), more work is needed on identifying priority sectors for liberalization on a country-by-country, sector-by-sector basis. Similarly, the gains to developing countries from more liberal regimes for the temporary movement of natural persons (Mode 4) in high-income countries would be potentially huge. High-income countries themselves should, on aggregate, also benefit from an inflow of temporary workers, although their relative wage structure would change and real wages for low-skilled workers might even decline. More work would be helpful on how those negative effects can be contained, as well as on the possible negative impact on developing countries from the brain drain inevitably associated with temporary migration.

In sum, what is required is a multi-faceted, largely country- and sector-specific assessment of the effects of more liberal trade in services. By its very nature, such analysis will involve a wide range of contributors from governments, civil society, academia, and international organizations. Depending on their political preferences and the influence of special interests, governments are bound to draw different conclusions from the evidence for their negotiating positions. Occasional reviews of the state of knowledge in these areas by the Council for Trade in Services may be useful, not least for negotiators from small or poor countries who may find it difficult to follow this evolving literature. There is no discernible need, however, for the Council to agree on detailed conclusions from this large body of research. Since the GATS negotiating framework leaves members free to limit liberalization to areas where they feel confident about the likely effects, each member would expect to determine its negotiating positions in accordance with their own conclusions from the ongoing debate.

4 Barriers to Trade in Services: Liberalization Potential and Access Barriers

4.1 Liberalization Potential

When services were brought into the brief of the newly created WTO at the 1994 Marrakesh Ministerial, a framework for negotiations and commitments on service sector liberalization was created, but little actual liberalization occurred. Hence, without having an idea how narrow or wide-sweeping the commitments might be and actually not really aware of how large the access barriers were, little could be forecast and turned into sensible hard numbers on the impact of the liberalization. It is thus hardly surprising to determine that the initial major estimates of the impact of the Uruguay Round (UR) basically ignored the service sector: Only one estimate included the service sector, and it was viewed as accounting for a mere 14 percent of welfare gains from liberalization and market access improvements

(see Table 1.1). Overall the largest welfare gains were attributed to the elimination of barriers to trade in the exportation of textile and clothing products, followed by the agriculture sector.

In the meantime, however, it has become quite apparent that the potential global impact of the liberalization in the service sector is immense (see Chapter 5). In a recent general equilibrium model, which includes foreign direct investment, Dee and Hanslow (2000) show how a "comprehensive removal of restrictions on all modes of service supply, including restrictions on services delivered via FDI … will impact on developing countries ... [they are] projected to be better off by U.S.$130 billion. The services sectors in most developing countries are projected to expand much more rapidly than developed economies [see Table 4.1].[13] As their relatively high restrictions on entry are removed, their services sectors develop, primarily funded by FDI, and they become major exporters of services" (McGuire 2002: 9–11).

Table 4.1:
Effects of Liberalizing Trade in Services[a,b] (Percentage and U.S.$ millions)

	Change in real income by sector					
	Percentage change			Absolute change in U.S. dollars		
	Primary & secondary	Tertiary	Total	Primary & secondary	Tertiary	Total
Developing Economies						
Chile	0.7	0.4	1.1	45	330	375
China	3.4	14.6	18.0	14,088	90,869	104,957
Indonesia	0.7	5.1	5.9	1,451	2	470
Malaysia	3.7	0.7	4.5	3,532	1,015	4,547
Mexico	0.3	0.1	0.4	–83	357	274
Philippines	5.1	0.4	5.5	1,601	1,236	2,837
Republic of Korea	1.5	0.1	1.6	8,784	1,886	10,670
Taiwan Prov. of China	2.7	0.2	3.0	11,659	–142	11,517
Thailand	2.6	0.2	2.8	4,063	1,698	5,762
Rest of the Cairns Group	1.2	0.1	1.3	12,766	6,970	19,736
Rest of the world	1.1	0.8	1.9	11,324	23,039	34 363
Total				**69,230**	**129,728**	**198,959**
Developed Economies						
Australia	0.2	0.0	0.2	1,994	2,098	4,092
Canada	0.1	–0.1	0.0	539	499	–1,038
European Union	0.1	0.0	0.1	6,394	–6,169	225
Hong Kong (China)	0.2	1.0	0.9	916	5,896	6,812
Japan	0.3	0.0	0.3	20,964	4,130	25,094
New Zealand	1.2	–0.1	1.1	4,400	257	4,657
Singapore	–0.3	–1.3	–1.5	7,421	–247	7,174
United States	0.2	–0.1	0.1	22,734	–1,809	20,925
Total				**64,284**	**3,657**	**67,941**
World				**133,514**	**133,385**	**266,900**

[a]Figures may not add up to total because of rounding. — [b]These are the projected gains in real income about 10 years after liberalization has occurred and the associated resource adjustments have taken place.

Source: Dee and Hanslow (2001: 18).

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[13] An examination of restrictiveness indices across seven service sectors revealed that on average foreign service providers in service sectors in developing countries were more restrictive than those in developed countries by 32 percent. The index for the most restrictive sector (banking) was 322 percent higher in developing countries than in developed countries; the index for the least restrictive sector (distribution) was 10 percent higher. Based on own calculations from WTO (2003: 142).

But how large is the potential in developing countries? The importance of eliminating barriers to trade in services is expressed not only in the sheer size of services in the world economy, where it amounts to roughly 60 percent of GDP. Almost as important is their economic share in developing countries, where roughly 80 economies reveal a service sector exceeding 50 percent. Furthermore, over 85 percent of the developing countries listed in the *World Development Report* (World Bank 2003) have larger service sectors than industrial sectors. And, given that roughly one-third of world trade can be seen as being generated by services (Karsenty 2000) it is hardly correct any more to consider services to be of nontraded nature. As Karsenty points out, traditional trade in services, that is cross border transactions, is larger than establishment-related trade in services.

Furthermore, knowing that some of those countries relatively most dependent on services are also some of the poorest (e.g., Armenia, Lesotho, and Kiribati) there is every reason to ensure that barriers to service trade are eliminated to ensure that their welfare potential can be tapped. As a matter of fact, as Dee and Hanslow (2001) contend, eliminating such barriers to trade in services could equal the elimination of trade barriers in agriculture and in industrial products. But what are the barriers to trade in services?

4.2 Barriers to Access

As large as the above-mentioned potential might be, tapping it is much more difficult than in the case of merchandise trade. There, at least, import tariff rates are a known quantity, whereas most measures restricting trade in services are of a nontariff nature (i.e., difficult to capture and portray) and most measures also occur behind the border. The question is how to classify nontariff measures/barriers[14] so as to allow their relative importance as well as their possible impact to be portrayed and then to develop a clear picture of how distorted/restricted an economy is vis-à-vis imports of goods and services.

Numerous classifications of NTBs for goods have been put forth (see Tables 4.2a and 4.2b). While such classifications help to better understand the scope of nontariff measures (NTMs), they say little about how pervasive such measures are. If their impact can be expressed in terms of additional time spent in moving the goods to the final destination, then implicit tariff equivalents could be imputed in line with Hummels (2001). The method he used incorporated the calculation of the increase in the final landed price due to an additional day on the road. But in many cases, as can be deduced from Table 4.2, the extra time spent and hence the tariff equivalent of such measures would be subject to wide variations if they could be captured at all with this method.[15] In any case, the initial barriers to trade applied to goods entering a country today are governed by the basic GATT 1947 principles. They are primarily ad valorem tariffs on f.o.b. values, applied on an MFN basis. Hence, the extent of protection that they afford is easy to calculate.

In the area of services the story is much more complicated as there is no tariff equivalent which can be quickly compared to merchandise trade barriers. How then can barriers be assessed and formulated in terms of protection equivalents for cross border transactions (Mode 1), consumption abroad (Mode 2), commercial presence (Mode 3), and presence/movement of people (Mode 4)? In practically all of the above cases one is talking about regulatory barriers which do not necessarily discriminate against foreigners but frequently prevent any new entry in the specific service sector.

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[14] As Bora (2003: 1) points out the literature uses both the term "non-tariff barriers" as well as "non-tariff measures." The rationale of "measure" is that it captures policies like export subsidies. An export subsidy, which is supposed to increase the exports for a specific sector, can hardly be called a barrier, at least not in the country in which it is granted. It could, however, be considered a barrier for those exports hit by the subsidized exports; but using such a definition would extend beyond what is normally understood.

[15] Here again difficulties occur because, even without a formal distinction, a given measure may in practice be applied differently to domestic vs. foreign businesses.

Table 4.2a:
Comparison of UNCTAD and Deardorff and Stern Taxonomies of NTMs

UNCTAD TRAINs	Deardorff and Stern
Price control measures	Quantitative restrictions and similar specific limitations on imports or exports
Administrative pricing	Import quotas
Voluntary export price restraint	Exports limitations
Variable charges	Licensing
Antidumping measures	Voluntary export restraints
Countervailing measures	Exchange and other financial controls
Finance control measures	Prohibitions
Advance payment requirements	Domestic content and mixing requirements
Multiple exchange rates	Discriminatory bilateral agreements
Restrictive official foreign exchange allocation	Countertrade
Regulations concerning terms of payment for imports	Nontariff charges and related policies affecting imports
Transfer delays	Variable levies
Automatic licensing measures	Advance deposit requirement
Automatic license	Antidumping duties
Import monitoring	Countervailing duties
Surrender requirement	Border tax adjustments
Quantity control measures	Government participation in trade; restrictive practices; general policy
Nonautomatic licensing	Subsidies and other aids
Quotas	Government procurement policies
Import prohibitions	State trading, government monopolies, and exclusive franchises
Export restraint arrangements	Government industrial policy and regional development measures
Enterprise specific restrictions	Government financed research and development; technology policies
Monopolistic measures	National systems of taxation and social insurance
Single channel for imports	Macroeconomic policies
Compulsory national services	Competition policies
Technical measures	Foreign investment policies
Technical regulations	Foreign corruption policies
Pre-shipment formalities	Immigration policies
Special customs formalities	Customs procedures and administrative practices
Obligation to return used products	Customs valuation procedures
Miscellaneous measures for sensitive product categories	Customs classification procedures
Marketable permits	Customs clearance procedures
Public procurement	Technical barriers to trade
Voluntary instruments	Health and sanitary regulations and quality standards
Product liability	Safety and industrial standards and regulations
Subsidies	Packaging and labelling regulations, including trademarks
	Advertising and media regulations

Source: Bora (2003:14).

Table 4.2b:
WTO/GATT Inventory of Nontariff Measures

Parts & sections	Description
Part I	**Government Participation in Trade and Restrictive Practices Tolerated by Governments**
A	Governments aids
B	Countervailing duties
C	Government procurement
D	Restrictive practices tolerated by governments
E	State trading, government monopoly practices, etc.
Part II	**Customs and Administrative Entry Procedures**
A	Anti-dumping duties
B	Valuation
C	Customs classification
D	Consular formalities and documentation
E	Samples
F	Rules of origin
G	Customs formalities
Part III	**Technical Barriers to Trade**
A	General
B	Technical regulations and standards
C	Testing and certification arrangements
Part IV	**Specific Limitations**
A	Quantitative restrictions and import licensing
B	Embargoes and other restrictions of similar effect
C	Screen-time quotas and other mixing regulations
D	Exchange control
E	Discrimination resulting from bilateral agreements
F	Discriminatory sourcing
G	Export restraints
H	Measures to regulate domestic prices
I	Tariff quotas
J	Export taxes
K	Requirements concerning marking, labelling and packaging
L	Others
Part V	**Charges on Import**
A	Prior import deposits
B	Surcharges, port taxes, statistical taxes, etc.
C	Discriminatory film taxes, use taxes, etc.
D	Discriminatory credit restrictions
E	Border tax adjustments
F	Emergency action

Source: WTO document TN/MA/S5, 11 September, 2002.

Examples of Types of Barriers by Mode

Some examples may be given in the following list:

Mode 1: Restricted access to e-commerce;
Mode 2: Medsical treatment abroad not covered by consumer's home country health insurance;
Mode 3: Commercial presence permitted but stipulations on location/number of branches;
Mode 4: Expertise drawn from abroad not accepted because local credentials required.

It is obvious from this brief list that putting a hard number on the tariff equivalent of such barriers is not possible. We are dealing with an area here where market failures and where natural monopolies can occur (e.g., telecommunications, air transport). Furthermore, professional services, health, and education must be considered to encompass asymmetric information. In many cases the restrictions applied to service sector entry were initially possibly imposed to deal with market failures, and at that point in time not really intended to be protective. But, as often the case, the underlying reasons for such fiefs tended to be forgotten, so that permanent claims were staked and protectionist structures evolved.

Measuring Barriers to Service Trade

As in the case of goods one possible approach to measuring the size of barriers to trade might be to simply compare the price of services in various countries. Deardorff and Stern (1997) have shown, however, that comparing the price of a can of Coke in different countries has little to do with comparing the price of telephone calls. The reason is simply that services are highly differentiated products (Ethier and Horn 1991). They are differentiated by:

- economies, due to different legal systems or accounting systems;
- firms, which differ due to firm-specific human capital;
- needs/demands in the various countries;
- fixed training costs, R&D in headquarters lead to economies of scale;
- services with industrial organization characteristics of multinationals.

For example, a domestic telephone call over the distance of 800 km in Germany is different from a call of the same distance in Canada due to technical, legal, and accounting systems. Or in the case of legal services, regulations can keep out foreign lawyers by allowing them to practice only home-country law. Furthermore, economic activities in different countries reflect different needs and demands, be it by firms or individuals. A tax accountant in Hong Kong will be asked entirely different questions than one in Mumbai. Likewise the divorce services a lawyer provides in Tokyo are different than those in Auckland. But even here, these differences are all the greater, knowing that needs and demands differ between individuals and professionals in a given country and have to be adapted accordingly. Similarly, services provided by Microsoft are different from those of any other software company because of Microsoft's firm-specific human capital. The development and maintenance of fixed and sunk costs, the organizational model involving product differentiation and economies of scale are all attributes of multinational firms, which also fits well to service industries (Markusen 1995).

Given this high degree of differentiation, the use of domestic/foreign price comparison techniques or other associated measures (e.g., producer/consumer subsidy equivalents) is not appropriate. "All such price comparison measures assume that the foreign price is a good 'benchmark' measure of what the domestic price would be in the absence of the trade distortions. But this presupposes that the domestic and foreign goods are perfect substitutes. For services, this is not the case" (Dee 2003a: 4).

Instead, counterfactual evidence needs to be constructed from econometric models about determinants of domestic prices; in other words, estimating what the domestic price would be in absence of distortions. These studies have been carried out using cross-country datasets to quantify "a cross-

country average" relation between barriers and performance, controlling for all other factors that affect performance. They have either been carried out across specific industries to estimate the sectoral effects or were applied with economy-wide models to try to pick up the overall effects of service trade barriers (see overview in Table 4.3).

Table 4.3:
Sectoral and Economy-Wide Studies of the Effects of Service Trade (and Other Regulatory) Barriers

Sector in which barriers occur	Study	Performance measure	Growth or level effects	Cross-country or panel
		Sectoral		
Air passenger transport	Gonenc/Nicoletti (2000)	Airfares Load factors Airline efficiency	Level	Cross-country
	Doove et al. (2001)	Airfares	Level	Cross-country
Banking	Kalirajan et al. (2000)	Net interest margin	Level	Cross-country
	Claessens et al. (2001)	Net interest margin Noninterest income Overhead expenses	Level	Panel
	Barth et al. (2004)	Bank development[a] Net interest margin Overhead cost Nonperforming loans Probability of bank crisis	Level	Cross-country
	Dee (2003b)	Net interest margin	Level	Cross-country
Distribution	Kalirajan (2000)	Cost	Level	Cross-country
Electricity generation	Steiner (2000)	Price Utilization rates Reserve plant margins	Level	Panel
	Doove et al. (2001)	Price	Level	Panel
Maritime	Kang (2000)	Price	Level	Cross-country
	Fink et al. (2001)	Price	Level	Cross-country
	Clark et al. (2002)	Costs	Level	Panel
Professions: engineering	Nguyen-Hong (2000)	Price Costs	Level	Cross-country
Telecommunications	Warren (2000)	Quantity Price	Level	Cross-country
	Trewin (2000)	Cost	Level	Panel
	Boylaud/Nicoletti (2000)	Price Labor productivity Quantity	Level	Panel
	Doove et al. (2001)	Price	Level	Panel
	Dee (2003b)	Quantity Price	Level	Cross-country
	Fink et al. (2003)	Quantity Productivity	Level	Panel
		Economy-wide		
Construction	Hoekman/Francois (1999)	Aggregate service exports	Level	Cross-country
Finance	Francois/Schuknecht (2000)	Not defined	Growth	Cross-country
	Eschenbach/Francois (2002)	Per capita GDP	Growth	Panel
	Mattoo et al. (2001)	Per capita GNP	Growth	Panel
Telecommunications	Hoekman/Francois (1999)	Aggregate service exports	Level	Cross-country
	Mattoo et al. (2001)	Per capita GNP	Growth	Panel

[a]Bank credit to the private sector as a share of GDP.

Source: Updated from Dee (2003b).

4.3 Measuring Restrictions

Table 4.3 summarizes recent studies that measure systematically barriers to service imports. Basically, these studies start from qualitative information about individual restrictions, assess and quantify their impact, and summarize this information into an index.[16] More specifically:

- First, qualitative information on restrictions and regulations is gathered from international organizations (WTO, UNCTAD, trade organizations, governments, etc.).
- Second, the information is classified by grouping similar restrictions together so their degree of restrictiveness can be compared across countries.
- Third, an index is developed to classify restrictions by their restrictiveness or openness. The index uses scores and weights to turn the qualitative into quantitative information. Scores are used to designate the strength of the impact of restrictions, and weights are used to capture their presumed relative importance. The restrictiveness index usually covers the range 0 to 1, whereby 0 is most open and 1 is most restrictive.
- Fourth, the total index is then calculated across the service sectors.

Using McGuire's (2003: 41) simple example it is easy to perceive how a relatively clear picture can be developed about the restictiveness/openness of a set of rules/regulations determining the issuing of banking licenses (Table 4.4). The simplicity and straightforwardness of the method does not mean, however, that the index "objectively" reflects the impact of the restrictions, since judgments have to be made about the degree of restrictiveness and the importance of the restriction. Nonetheless, given the wealth of literature on the impact of regulations it would seem to be possible to capture the overall thrust of rules and regulations. This is all the more the case if—where necessary—country-specific characteristics have been incorporated into the index

For example, the restrictiveness index for banking licenses (Table 4.4) can be expanded to cover all banking services provided by domestic and foreign institutions (Table 4.5). Figure 4.1 summarizes the degree to which a given country's regulations discriminate between foreign and domestic service providers. Applying this approach to banking services across a set of countries yields Figure 4.2, which provides a relatively good first-cut insight into major differences across countries.[17] It is then possible, for example, to examine whether such discriminatory differences can be related to specific economic and financial difficulties in the specific countries.

In a broader sense, such restrictiveness/openness indices lend themselves to investigating whether liberalization has indeed led to positive economic and social developments. Figure 4.3 shows that countries with higher restrictiveness indices for their service sectors tended to be poorer in terms of GDP per capita. This raises the question of how, specifically, causality runs from restrictions on service imports to economic development.

To the extent that certain barriers for a given industry can be identified and quantified, it would be possible to use this information to determine how these barriers have contributed, relative to other factors, to a country's overall economic and social development. For example, since the financial service industry plays a key role in economic development, how has its efficiency been affected by restrictions and what has been the impact on economic growth (Chapter 6)?

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[16] As McGuire (2003: 38) points out, there are two different approaches to determining the impact. One concentrates on measuring the level of restrictions on services by converting qualitative information about import barriers into quantitative information. The other seeks to measure the impact of rectrictions on the price-cost margins. The above sections draws heavily on the excellent overview prepared for the OECD by McGuire (2003).

[17] As McGuire notes (2000: 14–15) the scores for each restriction are based on judgment as to how binding it is. For instance, a restriction limiting the number of banking licenses is considered to be more restrictive than one which issues new banking licenses only if prudential criteria are fulfilled. The various restriction categories are finally weighted together based on judgments vis-à-vis there economic costs, given best information available. For example: restrictions on banking licenses considered to be more severe than restrictions on temporary movement of people. The weights are chosen so that the index ranges from 0 to 1.

Table 4.4:
Calculating a Restrictiveness Index on Distribution of Banking Licenses

Weight for type of restriction	Score for an openness index	Score for restrictiveness index	Restrictions on banking licenses
0.25	0.00	1.00	No new banking licenses available
	0.50	0.50	No foreign banking licenses available
	1.00	0.00	Banking licenses granted if prevailing prudential requirements met

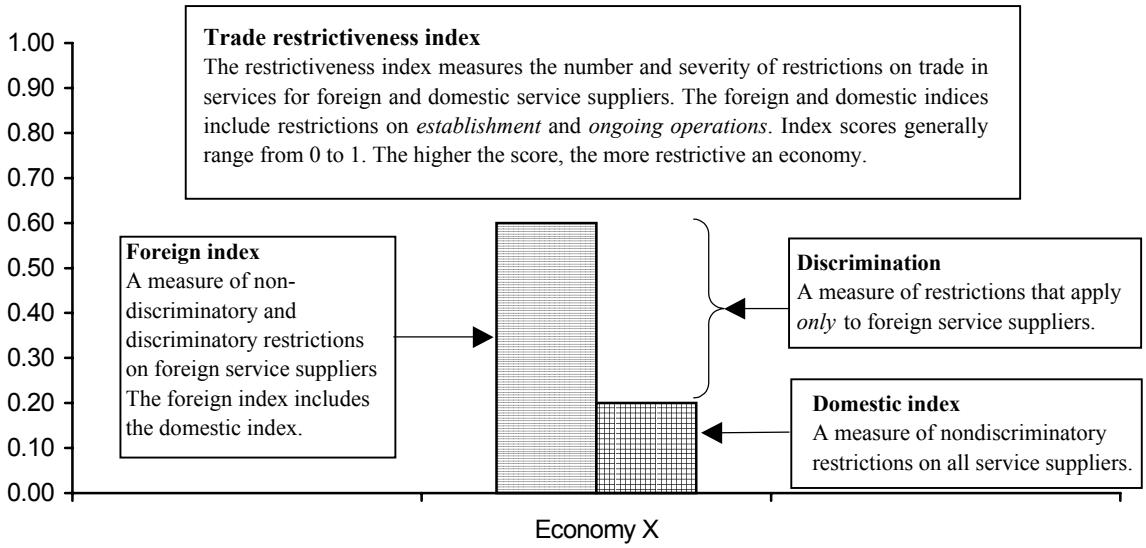
Table 4.5:
Restriction Categories for Banking Services

Restriction category	Relevant for foreign index	Total weight	Relevant for domestic index	Total weight
Restrictions on commercial presence				
Licensing of banks Based inversely on the maximum number of new banking licenses issued with only prudential requirements	Yes	0.200	Yes	0.190
Direct investment Based inversely on the maximum equity participation permitted in an existing domestic bank	Yes	0.200	Yes	0.190
Joint venture arrangements New bank entry only through joint venture with a domestic bank	Yes	0.100	No	n.a.
Permanent movement of people Based inversely on years that executives, specialists, and/or senior managers can stay	Yes	0.020	No	n.a.
Other restrictions				
Raising funds by banks Banks are restricted from accepting deposits from the public and/or raising funds from domestic capital markets	Yes	0.100	Yes	0.143
Lending funds by banks Banks are restricted in types or sizes of loans and/or are directed to lend to housing and small business	Yes	0.100	Yes	0.143
Other business of banks—insurance and securities services Banks are excluded from insurance and/or securities services	Yes	0.200	Yes	0.095
Expanding the number of banking outlets Based inversely on the number of outlets permitted	Yes	0.050	Yes	0.048
Composition of the board of directors Based inversely on the percentage of the board that can comprise foreigners	Yes	0.020	No	n.a.
Temporary movement of people Based inversely on the number of days temporary entry permitted to executives, specialists, and/or senior managers	Yes	0.010	No.	n.a.
Total weighting or highest possible score		1.000		0.808

Source: McGuire and Schuele (2000: Tables 12.1 and 12.3, pp. 204–5, 208).

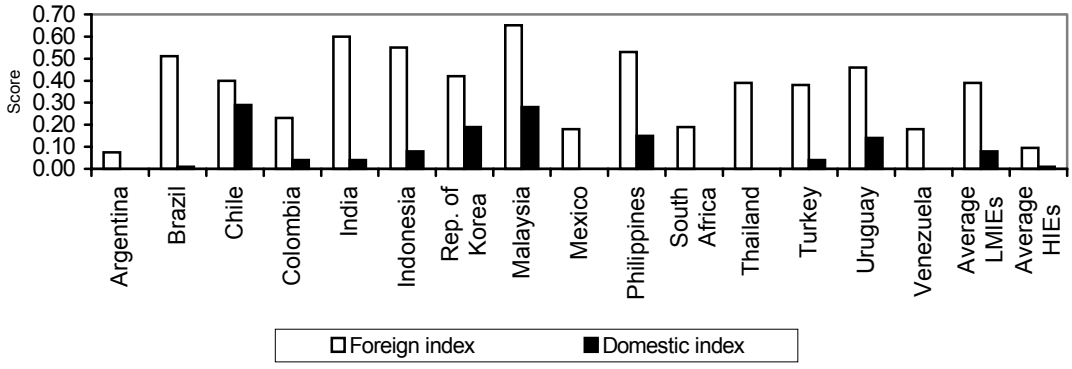
Against this background, it is important to identify those service sectors whose efficiency is held back by import barriers or other restrictions, and whose high prices or low quality, in turn, inhibit a country from effectively tapping its development potential. Spinanger and Verma (2003) examine key factors determining the competitiveness of economies: What are the essential factors that determine how successful a given economy is in attracting investors to establish production facilities or source from the country?

Figure 4.1:
An Illustration of the Results from the Trade Restrictiveness Index (Score)



Source: McGuire (2003: 42).

Figure 4.2:
Banking Services[a] (Score)



[a]Based on available information on restrictions in place as at 31 December 1997.

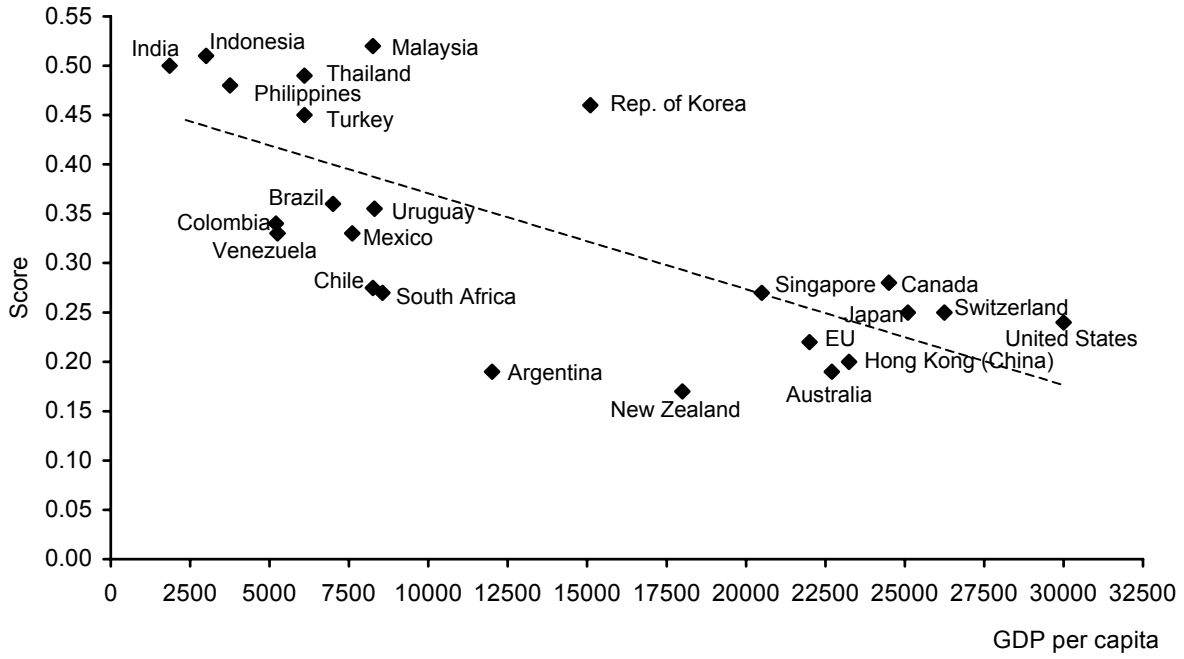
Source: McGuire (2003: 43).

To find this out two surveys were carried out among 14 major textile and clothing producers and traders in Hong Kong in January 2000, and February/March 2003. The companies had activities in Hong Kong, China, throughout Asia and around the world. Some of them were major players, others were businesses of medium size. In all cases, the individuals had senior positions in their firms, most were owners, chief executive officers (CEOs), or managing directors. In all but one case were the individuals contacted in 2003 the same as those in 2000.[18] In the survey they were asked to state the relative importance of 18 factors determining where they would buy/source products or invest in manufacturing facilities.[19] Respondents were requested to give a "gut" reply to each factor by responding

[18] For the overriding issues it is assumed that the answers apply to the economy in general and not just to the textile and clothing industry.

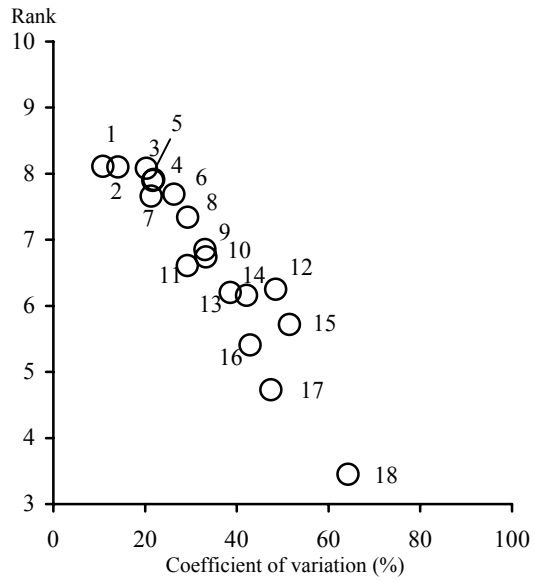
[19] The factors selected were those usually found in the relevant literature.

Figure 4.3:
GDP per Capita at PPP and Average Foreign Trade Restrictiveness Index Scores for the Service Sector (Score and GDP per capita at purchasing power parity)



Source: World Bank (2001); Productivity Commission (2001).

Figure 4.4:
Ranking of Factors Influencing Investment Decisions: 2003



1 Labor costs
2 Policies affecting international trade and investment
3 Politics and stability in host country
4 Policies affecting labor, health, and environment
5 Quality of transportation infrastructure in host country
6 Lack of restrictions on capital/profit transactions
7 Quality of telecom infrastructure in host country
8 Host government tax policies/incentives
9 Potential for exports to USA
10 The "culture" of host country
11 Education and training of workers
12 Potential new customers/new markets
13 Availability of quotas in host country
14 Potential for exports to EU
15 HKG tax policies
16 Availability of ready-made factory units
17 Potential for exports to region
18 Existence of Overseas Chinese Community

Source: Based on interviews with CEOs from 14 textile/clothing companies as well as large trading companies in Hong Kong (02/2003). See also text.

Table 4.6:
List of Key Factors Determining the Competitiveness of Economies

1	Labor costs	5	Quality of transportation infrastructure in host country
2	Policies affecting international trade and investment	6	Lack of restrictions on capital/profit transactions
3	Politics and stability in host country	7	Quality of telecom infrastructure in host country
4	Policies affecting labor, health, and environment		

Source: Spinanger and Verma (2003).

with a number between "10" if a factor was totally and absolutely important, and "1" if it was totally and absolutely unimportant.

The overall results of the survey for 2003 (quite similar to the 2000 results) are presented in Figure 4.4. They clearly portray what factors help keep countries competitive. The information provided in this Figure 4.4 is a plot of the average rankings (scores) given to each question (on the vertical axis) against the coefficient of variation (on the horizontal axis). The resulting downward-sloping pattern portrays those questions with little variation in rankings between companies (i.e., low coefficient of variation) but high average ranking values on the upper left side of the figure and those answers with a high variation (i.e., high coefficient of variation) on the bottom right, but lower average ranking values on the left.

Figure 4.4 clearly reveals three groupings of factors that influence investment and sourcing decisions (Factors 1 through 7; 8 through 11; 12 through 18). The first group encompasses the key issues that shape investment and sourcing decisions, and thus the decision to tap the development potential of countries (Table 4.6):[20] Notably, two of the seven key factors relate to the quality of service provision, namely transport and telecommunications infrastructure. Both are largely internationally tradable services where the quality of service provision depends directly on policies for trade in services (Limao and Venables 2001).

5 Income Effects of Service Import Liberalization by Developing Countries: Overview

This chapter surveys recent studies that categorize and quantify the effects of trade liberalization in services. Such studies provide important background information for governments setting out to determine the direction of their policies for service sector development and liberalization. At the same time, broad-based studies such as those presently surveyed need to be complemented with more detailed, country- and sector-specific work as specific negotiating positions are developed. In line with our earlier discussion (see Chapter 3 above), this chapter (i) focuses on sectors that do not involve network monopolies and hence offer a prospect of enhanced competition post-liberalization; (ii) assumes that the import barriers under review are not redundant (hence reducing them leads to higher imports); (iii) deals mostly with market access restrictions and denial of national treatment and does not extend to the possible abuse of domestic regulations as trade barriers (which does not lend itself to generalizations in any case); and (iv) is based on the understanding that, apart from the temporary movement of natural persons, developing countries will enjoy benefits from liberalization mostly to the extent to which they themselves liberalize (see also Hoekman 2000).

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[20] This is assumed to prevail even if in this case they were executives (mainly Chinese, but also foreign nationals in Hong Kong) only in the textile/clothing sector and trading houses.

5.1 Conceptual Issues

As background for the review of empirical studies in Section 5.2, it is useful to categorize the potential sources of income effects of liberalizing service imports, focusing on Modes 1 to 3.[21] The immediate effect of reducing a (binding) trade barrier or market access restriction is to increase competition, leading to some combination of greater product variety, higher quality, or lower prices.[22] The subsequent reallocation of factors of production within the economy yields the traditional static welfare effect. Typically, empirical estimates suggest that this effect is small. However, in the important case of producer services, several studies suggest that unless the availability and quality of such services exceed some threshold level, "downstream" manufacturing industries find it impossible to export successfully (Markusen et al. 1999; Francois and Wooton 2000). If, following import liberalization, previously unavailable producer services become available and manufactured exports expand, the static welfare effects of service import liberalization are likely to be substantial .

In addition to static welfare and income effects resulting from more appropriate specialization and fuller factor utilization, the liberalization of service imports also has dynamic effects through its impact on capital formation. Typically, the increase in GDP estimated from these dynamic effects is a multiple of the static welfare effect of trade liberalization. In the case of services, such dynamic effects may arise directly, as restrictions on foreign direct investment are lifted, or indirectly, as economy-wide total factor productivity and hence the rate of return on investment increase.

In principle, the potential benefits of trade liberalization need to be weighed against its short-term and long-term costs. In the short run, greater import penetration may result in unemployment or underutilization of factors of production as inputs cannot be shifted out of declining sectors instantaneously and newly competitive industries expand only gradually. Though potentially important, not least politically, these costs are difficult to measure since the exact adjustment path following trade liberalization is difficult to predict. As a way of minimizing short-term adjustment costs, trade liberalization is typically phased in over time, allowing suppliers to adjust their capacity in time for changes in competitive environment.

In a dynamic perspective, it has been argued that some infant industries require protection during a start-up phase before they can achieve reductions in per unit production costs along a learning curve and thus become internationally competitive. As per unit production costs decline, so should protection. According to this argument, capital markets are imperfect and will not finance a new industry based only on the prospect of lower production costs and enhanced competitiveness in the future. Furthermore, government subsidies (which would be preferable to protection on welfare grounds) are limited by fiscal constraints.

In principle, the GATS leaves members free to protect particular service sectors. Art. XV contains a negotiating mandate on subsidies that may distort trade; however, there are no current restrictions and the negotiating mandate explicitly calls for recognition of the role that subsidies may play as part of

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21 *Cross-border supply* (Mode 1) is defined to cover service flows from the territory of one member into the territory of another member (e.g., banking or architectural services transmitted via telecommunications or mail). *Consumption abroad* (Mode 2) refers to situations where a service consumer (e.g., tourist or patient) moves into another member's territory to obtain a service. *Commercial presence* (Mode 3) implies that a service supplier of one member establishes a territorial presence, including through ownership or lease of premises, in another member's territory to provide a service (e.g., domestic subsidiaries of foreign insurance companies or hotel chains). *Presence of natural persons* (Mode 4) consists of persons of one member entering the territory of another member to supply a service (Art. I of the GATS). The GATS Annex on Movement of Natural Persons specifies that members remain free in their policies regarding citizenship, residence or access to the employment market on a permanent basis.

22 As discussed in Chapter 3 above, if network or other monopolies in a particular sector prevent greater competition, the following reasoning does not apply.

development programs of developing countries.[23] Only after a specific commitment has been made does it becomes difficult to reverse it (GATS Art. XXI; see Section 2.1) and increase protection beyond the bound level. To the extent to which the infant-industry argument is valid, a potential cost of liberalization under the GATS consists in precluding the granting of infant-industry protection to a particular sector in the future when the desirability of such protection cannot be identified at present.

While the infant-industry argument is theoretically sound, experience with industrial policy for manufacturing industries in many developing countries suggests strongly that the political process tends to subvert the effective provision of infant-industry protection. Very frequently, protection has become entrenched rather than remaining temporary, at far greater loss to the economies than could have been caused by any initial market imperfection. For the purpose of this paper, it is safe to assume that any negative effects from failing to provide infant-industry protection would be small; furthermore, they would be more than offset by the benefits that stem from eliminating the risk that infant-industry protection might become entrenched.

5.2 Numerical Estimates

Dihel (2003a) has recently surveyed the empirical literature on the measurement of trade barriers for services and the estimation or simulation of the income gains from trade liberalization. Several papers from the second half of the 1990s use broad-brush estimates of the tariff equivalents of sectoral protection from Hoekman (1995); assuming that the ad valorem equivalents of all service import barriers are cut by up to one-half, these studies typically estimate the GDP or welfare gains at somewhere between one-tenth of a percentage point and 2 percentage points of GDP, after allowing for adjustments in FDI stocks. Estimates for many developing countries with significant service trade barriers tend to be at the higher end of this range; for example, Konan and Maskus (2002) estimate that household income in Tunisia would grow by 5 percent in response to service liberalization, mostly through the impact of additional FDI inflows. When liberalization is limited to particular sectors such as communication and financial services, the estimated increments in GDP naturally become smaller (Verikios and Zhang 2000).

These estimates are based on fairly highly aggregated simulation models. This raises the question of whether the results are borne out by the experiences of developing countries that have liberalized service imports, sometimes in conjunction with the privatization of state enterprises under IMF or World Bank conditionality. This question is often difficult to answer because, typically, the impact of trade liberalization is closely intertwined with that of structural reforms, to the point of being impossible to disentangle empirically. Frequently, also the affected sectors involve network monopolies and, hence, offer little prospect for enhancing competition after the reform, which we have previously identified as a precondition for the standard income gains from trade liberalization.

Nevertheless, telecommunications and financial services are examples of sectors that have undergone substantial reforms in a large number of developing countries and have often experienced enhanced competition as a result, not least because of recent technological advances in mobile telecommunications that eliminated land-line monopolies. Fink et al. (2003) analyze the impact of policy reform on sectoral performance in basic telecommunications in 86 developing countries in 1985–1999. They find that, on average, privatization combined with entry of new providers and the establishment of an independent regulatory agency increased teledensity by 8 percent and labor productivity by 21 percent. Furthermore, simultaneously privatizing the established provider and opening the market produced better results than sequentially introducing those reforms. While these improvements are sig-

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[23] Thus the only binding restrictions on subsidies to service suppliers are MFN treatment (unless an exemption has been listed) or national treatment (if a specific commitment has been made). This contrasts with much more stringent rules for subsidies affecting trade in goods (SCM Agreement).

nificant in size, privatization and market opening accounted only for a modest portion of the sharp improvement in total sector performance that was driven predominantly by technical progress.

Similar evidence is available for the financial service industry whose crucial contribution to economic development, by providing the channels through which savings turn into investment, is now widely acknowledged (see Chapter 6 below; Levine 1997). From cross-country regressions, Francois and Schuknecht (2000) find that financial sector openness (i.e., the presence of foreign banks in the domestic market, not necessarily involving capital account liberalization) is strongly and positively associated with competition in the sector. Furthermore, competition is strongly associated with economic growth, on top of the separate effect of financial sector development on growth (i.e., a highly competitive and highly developed financial sector is associated with a higher GDP growth rate than a less competitive and similarly developed sector). Overall, the *annual* GDP growth rates of countries that had fully opened their financial service industries were 1.3 to 1.6 percentage points higher than for countries with the "most closed" type of financial service regime. Similarly, Mattoo et al. (2001) find from cross-country growth regressions that countries with fully open telecommunications and financial service sectors grew up to 1.5 percentage points faster annually than other countries. These are huge growth effects; for example, with a 1.5 percentage point difference in annual growth rates between two countries, after 20 years GDP is 35 percent higher in the richer country.[24]

Why do simulation models and cross-country growth regressions produce such widely different estimates of the income gains from liberalization? Most importantly, simulation models reflect the short-to-medium-term impact of the particular reforms analyzed; by contrast, the coefficients of service sector openness variables in cross-country growth regressions in practice reflect a whole set of closely interrelated policy variables. Typically, measures of "good" macroeconomic and structural policies are highly correlated across countries. Since most growth regressions are specified parsimoniously, the service sector openness variable will often pick up the impact of a whole bundle of growth-promoting policies. In this sense, cross-country growth regressions demonstrate the long-term growth effects of interrelated institutional and policy reforms, including service sector openness. To improve growth performance in line with the coefficient estimates, developing countries would need to adopt a whole range of mutually reinforcing policies beyond service sector reform and opening.

Overall, the empirical evidence discussed in this section reinforces the notions that (i) in many developing countries, the potential GDP gains from liberalizing service imports to enhance competition are considerable, especially compared to further liberalization of merchandise imports; (ii) potential benefits are highly country-specific, and sectoral priorities for liberalization need to be established on a country-by-country basis.

6 Economic Effects of Service Import Liberalization: Focus on Financial Services

While cross-country regressions demonstrate the long-term benefits from comprehensive import liberalization in key producer services (Section 5.2), such studies offer little guidance regarding the impact of particular measures, complementarities between policies, or the appropriate timing and sequencing of liberalization. Therefore, to complement the bird's-eye view offered by these studies, this chapter approaches service import liberalization from a sectoral perspective. It focuses on the financial service industry, which is widely acknowledged to play an important role in economic development. Section 6.1 places the liberalization of financial service imports in the larger context of financial global-

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[24] The parameter estimates from cross-country growth regressions may be interpreted as indicative of long-run growth effects.

ization and financial sector liberalization. Section 6.2 reviews detailed empirical studies of the impact of foreign bank entry. Section 6.3 discusses selected country experiences with rapid financial sector liberalization, including foreign bank entry, in order to assess how the conclusions drawn from this literature are applicable across a wider range of countries.

6.1 Foreign Bank Entry, Financial Sector Development, and Financial Globalization: The Wider Context

Liberalizing financial service imports involves, most prominently, removing restrictions on the entry and activities of foreign banks. By increasing competition in the domestic market, import liberalization thus becomes part of the process of domestic financial sector liberalization. Furthermore, it is also closely linked to financial globalization—i.e., the integration of national financial markets. However, liberalizing foreign bank entry (which, ideally, establishes national treatment for foreign banks) is not tantamount to capital account liberalization, the main vehicle of financial globalization. The presence of foreign banks does not prevent the authorities from restricting certain types of capital exports by residents or capital imports by nonresidents.[25]

To demonstrate the importance of this distinction for policy, it is useful to review briefly the state of the debate on whether integration into world financial markets and, by implication, financial globalization promote economic growth. Better access to foreign savings could increase incentives for productive investment; however, Prasad et al. (2003) find that the productive use of additional foreign savings, which would be a precondition for higher growth, depends on whether a country has attained threshold levels of human capital development, domestic financial market development, domestic governance (encompassing transparency, control of corruption, and rule of law), and macroeconomic policy. Furthermore, financial integration is neither a necessary nor a sufficient condition for rapid growth. Some countries with a fairly closed capital account grew rapidly (China and India being notable examples), while others that were more open to foreign capital flows grew slowly (e.g., Peru and Jordan). Econometric tests of the relationship also generally fail to obtain a robust statistical relation between financial openness (*de jure* or *de facto*) and growth.[26]

By contrast, the case for domestic financial liberalization, including foreign bank entry, is more straightforward. In the past, policies of financial repression in developing countries—including high reserve requirement, interest rate ceilings, and credit rationing—were being justified on the grounds that they lowered the interest rate, thereby increased productive investment, and promoted economic growth (Denizer et al. 1998: 2). McKinnon (1973) and Shaw (1973) challenged this view arguing that "the distortions from financial repression crowd out high-yielding investments, create a preference for capital intensive project, discourage saving and thereby reduce both the quality and quantity of investment in a country" (Denizer et al. 1998). Furthermore, many governments use financial repression, not to promote growth, but to obtain "easy money," mainly to finance government deficits (Fry 1995; Denizer et al. 1998). Systematic empirical studies have found a strong positive association between financial development and growth, but there is still a debate about whether financial development is a cause or a consequence of growth (Goldsmith 1969; King and Levine 1993). Levine (2003a: 72) concludes from a comprehensive review that the econometric evidence "suggests that both financial intermediaries and markets matter for growth and that reverse causality alone is not driving this relationship."[27]

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[25] By contrast, the cross-border supply of banking services (e.g., residents depositing money abroad) does presuppose some measure of capital account liberalization (cf. FN 8 of GATS Art. XVI).

[26] Prasad et al. (2003) summarize the results of some 15 econometric studies of which all but 3 found no effect of financial openness on growth. See Edison et al. (2002).

[27] There is also an inconclusive debate on the relative suitability of bank-based and market-based financial systems for developing countries. Proponents of bank-based systems argue that banks do a better job of acquiring information about firms

There is wide agreement today that there is a proper sequence to financial liberalization. Initially, domestic financial institutions and markets should be liberalized, including foreign bank entry, and good governance and prudential oversight should be ensured. Only then should countries consider opening up the capital account. As the 1997 Asian crisis amply demonstrates, opening the capital account prematurely may lead to perverse outcomes, including capital flight, less domestic investment and lower growth, as well as increased macroeconomic volatility. For many countries, the considerable risks from rapid capital account liberalization may well outweigh any benefits in the form of better access to international private capital markets.

6.2 Foreign Bank Entry: Competition, Efficiency, Financial Stability, and Access to Credit

Since a large number of both developed and developing countries have liberalized market entry for foreign banks since the 1980s, there is rich data available for systematic empirical studies on how foreign entry has affected the incumbent domestic banks as well as the quality and prices of the financial services received by customers. Specifically, researchers have focused on the impact on (i) competition and efficiency; (ii) the stability of the financial system; and (iii) access to credit.

First, foreign bank entry clearly intensifies competition in the domestic banking market, but does that lead to improved efficiency in the banking system as a whole and, in particular, does competition from foreign banks force domestic banks to become more efficient? The literature on this issue has focused mainly on banking markets in developed countries and has found that in developed countries foreign banks tend to be less efficient and less profitable than their local competitors. Within the past five years, new bank-level data have become available that has allowed researchers to address this question for developing countries. Interestingly, they find the opposite relationship—namely that the foreign banks tend to be more efficient and profitable than their domestic competitors (Clarke et al. 2001b). Indeed, it has been suggested that the inefficiency of domestic banks in the host countries is one of the attractions for foreign banks entering a new market (Focarelli and Pozzolo 2000).

Using bank-level data for 80 countries over the period 1988–1995, Claessens et al. (2001) find econometric evidence that "foreign bank entry can render national banking markets more competitive, and thereby can force domestic banks to start operating more efficiently" (p. 18). In particular, they find that the larger the share of foreign banks in the domestic banking market, the lower the profitability and the lower the operating costs of domestic banks. Thus, while the removal of restrictions on the entry and activities of foreign banks appears to lower the profitability of domestic banks, it does seem to improve the functioning of the banking system as a whole, with clear positive implications for bank customers and national welfare.

Another, more recent study (Claessens and Laeven 2003), using bank-level data for 50 countries over the period from 1994 to 2001 to estimate a structural model of competitiveness, finds similar results—"greater foreign bank presence and fewer activity restrictions in the banking sector can make for more competitive banking system" (p. 23). However, a more novel finding of this study is that the degree of concentration in the banking sector did not, contrary to what is often found, influence the competitiveness of the system. They interpret this result in the light of industrial organization theory which suggests that contestability, rather than industry structure, is most important for competition. This suggests that allowing for foreign bank entry is all the more important in banking systems that are highly concentrated, especially when the highly concentrated banks are state-owned.

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and overseeing managers than market-based systems (Stiglitz 1985; Shleifer and Vishny 1997; Allen and Gale 2000). Along these lines, Tadesse (2002) finds that market-based systems work better in countries with well-developed financial sectors, while bank-based systems do better in countries with underdeveloped financial systems. However, most of the empirical evidence is inconclusive (Demirgüç-Kunt and Levine 2001; Levine 2003b). Perhaps the structure of a financial system is less important for its functioning than the legal system upon which it is built (La Porta et al. 1998).

Asian countries, while having experienced rapid financial deepening in the recent years, continue to limit, in varying degrees, the penetration of domestic banking markets by foreign firms. However, as Claessens and Glaessner (1998: 51) show, the econometric findings based on cross-country data appear to apply in the Asia region as well. Net interest margins are lower, overhead costs are lower, and profits are higher in Asian banking systems that are more open to foreign bank participation. For Asian developing countries specifically, a recent study concludes that "the limited openness to date has been costly in terms of slower institutional development, greater fragility and higher costs of financial services" (Claessens and Glaessner 1998: 31).

Second, many financial crises in developing countries have been preceded by financial liberalization, including the liberalization of restrictions on foreign bank entry (Kaminsky and Reinhart 1999). It does not follow, however, that foreign bank entry contributes to the likelihood of a financial crisis in liberalizing countries. Indeed, evidence suggests that foreign banks had a stabilizing influence during the financial crises in Latin American and Asia in the 1990s.

A study of bank lending during the financial crises in Mexico and Argentina in the 1990s indicates that foreign banks were a stabilizing force (Goldberg et al. 2000). During the financial crises in these countries, and immediately thereafter, foreign banks exhibited stronger loan growth and less loan volatility than domestic banks, thereby contributing, according to the authors, to greater stability in the overall financial system (Goldberg et al. 2000: 23). The evidence from Mexico and Argentina suggests, according to this study, that "diversity in ownership appears to contribute to greater stability in times of crisis and domestic financial system weakness."

A separate study of bank lending in the East Asian countries that experienced banking crises in the late 1990s (Indonesia, Korea, Malaysia, the Philippines, and Thailand) finds that foreign banks took little risk relative to other banks in the region in the years leading up to the crisis (Laeven, undated). As a result, in the aftermath of the crisis, it was mainly domestic banks, not foreign banks, which had to be restructured. Cross-country evidence also indicates that foreign bank presence reduces the likelihood, other things equal, of a banking crisis (Demirgüç-Kunt et al. 1998), perhaps because systems that restrict foreign bank entry tend to have lower loan portfolio quality and greater fragility in the financial sector (Barth et al. 2004).

Because foreign banks have more diversified portfolios and greater access to funds through their parent companies, they are less exposed to risk and less affected by negative shocks in the host country. For this reason, Mishkin (2001: 26) suggests that "encouraging entry of foreign banks is thus likely to lead to a banking and financial system that is substantially less fragile and far less prone to crisis." Another reason for encouraging foreign bank entry, he suggests, is that foreign bank presence encourages the adoption of better risk management techniques by local banks and can induce regulators to demand better risk management techniques in the system as a whole.

Third, many foreign banks operating in developing countries lend mainly to larger companies, while domestic banks are more active in the areas of consumer credit and lending to smaller companies in the commercial and industrial sectors (Clarke et al. 2001a: 21). The orientation of foreign banks toward serving larger companies has raised a concern that an increase in foreign bank presence in developing countries may worsen the access to credit of small and medium-size companies (SMEs).[28] This outcome would be all the more likely if competitive pressure from foreign bank entry were to crowd out smaller domestic banks that are the principal lenders to SMEs in developing countries. This is of course an important issue because the expansion of SMEs is critical for labor-abundant developing countries that are pursuing an export-oriented industrial strategy.

It is possible, however, that foreign bank entry could improve the access to credit of SMEs in developing countries although foreign banks themselves are oriented toward larger borrowers. If foreign

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[28] Berger et al. (2000) find that small companies in Argentina are less likely to get credit from large domestic banks or from foreign banks than large companies. A similar pattern is found in Chile, Columbia, and Peru (Clarke et al. 2001b).

banks displace domestic bank lending to larger borrowers, the domestic banks may be forced to rely more on lending to SMEs. Moreover, if foreign bank entry increases overall competition and improves the borrowing terms for all customers, SMEs would likely benefit along with larger enterprises. The relationship between foreign bank entry and SME access to credit is, therefore, an empirical issue.

Empirical evidence on this issue for developing countries has only just begun to emerge. One of the first studies on this issue, by Clarke et al. (2001a), uses a survey of over 4,000 enterprises in 38 developing and transition economies to study the perceptions of borrowers regarding the impact of foreign banks on their access to credit and on the terms of borrowing. Their study confirms that foreign bank penetration of domestic banking markets in developing countries is perceived by borrowers to have improved banking services overall, giving borrowers greater access to credit and better terms (i.e., lower interest rates). Furthermore, they find that "the benefits of high levels of foreign bank penetration do not appear to accrue only to large enterprises" (p. 21). While it appears that larger enterprises benefit from foreign bank penetration more than smaller ones, they conclude that "there is strong evidence that even small enterprises benefit in some ways and there is no evidence that they are harmed by foreign bank entry."

A related study (Beck et al. 2003) using survey data for about 6,000 firms in 74 countries on firms' perceptions of financing obstacles reaches a very similar conclusion. Their results indicate that, in general, financing obstacles are greater in countries with more concentrated banking markets, and that the effect of market concentration on access to credit is more severe for the smaller firms. The negative effects on credit access to SMEs are less severe, they find, in countries with well developed financial institutions, higher levels of financial development, and a larger share of foreign-owned banks. To alleviate the negative impact of bank concentration, they recommend policy measures that reduce restrictions on banking activities overall and on the entry and activities of foreign banks in particular.

6.3 Country Experiences

This section complements our discussion of econometric studies (Section 6.2 above) by assessing individual countries' experiences with more liberal foreign bank entry in the broader context of their macroeconomic development. We first describe the challenges faced by Vietnam which was obliged under its bilateral trade agreement with the United States to open its banking sector to U.S. banks over a three-year period ending in December 2004. While the effects of foreign bank entry are not yet known, Vietnam's current position illustrates the issues faced by many developing countries considering financial sector liberalization under the GATS. We then turn to Turkey, Colombia, and Argentina, where the effects of foreign bank entry can be observed over a longer period of time, to point out the implications for Vietnam and other developing countries.

Vietnam

Vietnam is a particularly interesting case because, on the one hand, the financial system in this former socialist country is very weak, suffering from a high level of inefficiency nurtured during decades of isolation from market discipline and foreign competition. On the other hand, the United States—Vietnam Bilateral Trade Agreement (hereafter the BTA) obliges Vietnam to liberalize entry requirements for U.S. banks over a relatively short time horizon. Once Vietnam concludes its negotiations on accession to the WTO, the same conditions will apply to banks domiciled in all WTO member states. If foreign bank entry in Vietnam can be managed so as to provide benefits for customers and for the economy as a whole, this would be an encouraging example for other developing countries with highly repressed financial systems. At the same time, it is important to notice the weak negotiating position of countries that seek to join the WTO. As their accession depends on the political good will of incumbent WTO members, they typically face far more stringent demands for import liberalization (in ser-

vices as in other areas) than many incumbent WTO members would accept for themselves under the WTO's consensus-based decision-making procedure.

Of course, the BTA extends far beyond the banking sector. Since the agreement went into effect on December 10, 2001, the United States has granted Vietnam most-favored nation (MFN) status and national treatment, unleashing Vietnam's strong comparative advantage in labor-intensive manufactured goods. Total exports to the United States increased by 128 percent and manufactured exports by 500 percent in the first year of the agreement (2002).[29] At the same time, Vietnam has committed to bringing its trade and investment regimes, including but not limited to market access for U.S. banks, more closely into line with international best practices, with most transition periods ending at end-2004 (see Table 6.2).

The main concern in Vietnam is that full implementation of the BTA obligations will have deleterious effects on domestic banks, especially the state-owned commercial banks (SCOBs) with their large stock of nonperforming loans. Although little information on the financial health of banks is publicly available, it is clear that the four SOCBs account for 75 percent of the assets and liabilities of the banking system (Table 6.1). According to one international bank rating agency (Fitch Ratings), Vietnam's SOCBs are "effectively insolvent." The ratio of SOCBs' nonperforming loans to total outstanding loans according to Vietnamese accounting standards is 13 percent, but could be as high as 30 to 60 percent under international accounting standards.[30] According to the IMF, the capital cost of provisioning for the SOCBs nonperforming loans is estimated at 7 percent of GDP.[31] Most of the nonperforming loans of the SOCBs are owed by state-owned enterprises (SOEs), the main client base of SOCBs until very recently. SOCBs were also mandated by the government to finance SOE investments and operating losses, which in the 1990s were large in part due to reform measures intended to impose market discipline on the notoriously inefficient SOEs.

In addition to the 4 SOCBs, the banking system consists of 39 relatively small privately held joint-stock banks, 4 joint-venture banks, and 25 foreign branch banks.[32] As many as 54 joint-stock banks were established in the early 1990s, but closures and mergers have reduced the number and are expected to reduce it even further. The 4 joint-venture banks, all very small and together accounting for only three percent of bank loans, are each owned 50 percent by a SOCB and a foreign bank (one each from Malaysia, Korea, Taiwan, and Thailand). The 25 foreign branch banks, which together account for 15 percent of bank loans, have grown rapidly in recent years despite the restrictions imposed on their activities.

The joint-stock banks (JSB), without the moral hazard of an implicit government-guaranteed bailout, have focused their lending activities on private companies, real estate, and domestic consumers instead of SOEs. Nonetheless, the joint-stock banks have their own problems, including inadequate capital, insufficient scale, and too little banking experience, in particular in risk assessment and management. Several of the JSBs have, however, been quite successful in developing new banking products, attracting customers, and improving technology. Thus, the outlook, according to the Fitch Rating Service, is that "one would expect them (JSBs) to continue growing their share of the market going forward."[33] Foreign branch banks, which collectively account for 15 percent of outstanding loans, have increased their role in the domestic banking sector despite onerous restrictions on their activities.

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[29] See *An Assessment of the Economic Impact of the United States-Vietnam Bilateral Trade Agreement* (June 2003), the Annual Economic Report for 2002 of STAR-Vietnam, a USAID-funded project to assist the government of Vietnam in implementing the BTA.

[30] IMF Country Report No. 01/59, April 2001: 15; FitchRatings, "Country Report: The Vietnam Banking System," July 10, 2002: 6.

[31] IMF Country Report No. 01/59, April 2001: 15.

[32] In addition, there are about 42 representative offices of foreign banks, but they are prohibited from offering banking services in the domestic market.

[33] FitchRatings, "Country Report: The Vietnam Banking System", July 10, 2002: 7.

Table 6.1:
The Banking Sector as of December 2002[a] (VN dong billions)

	SOCBs	Non-SOCBs	Joint-stock banks	Joint-venture banks	Foreign branch banks
Number of banks	4	76	39	4	25
Bank capital	18,309	12,618			
Assets	297,072	102,590			
Loans	175,489	55,589			
To SOEs	81,600	7,900			
To Non-SOEs	93,889	47,689			
Share of loans (%)[b]	70	30	12	3	15
Liabilities	297,072	102,591			
Dong deposits	124,262	36,993			
Foreign curr. deposits	66,967	26,665			

[a]IMF unpublished data. — [b]World Bank, *Banking Sector Review*: Vietnam, 2003.

Table 6.2:
Timeline of BTA Commitments to Open the Banking Sector to U.S. Banks

Effective on December 10, 2001	• Number of U.S. branch banks no longer subject to a country quota
	• National treatment for U.S. shares in joint-stock commercial banks
Phased in from 2001 to 2010	• Joint ventures allow with U.S. equity between 30 to 49%
As from December 10, 2002	• U.S. branch banks are allowed to accept Vietnam dong deposits up to 50% of legal paid-in capital
As from December 10, 2004	• U.S. branch banks are allowed to take initial mortgage interest in land use rights (LURs) held by foreign invested enterprises
	• U.S. branch banks are allowed to acquire and use mortgages of LURs for liquidation in the case of default
	• U.S. branch banks have access to rediscounting, swap, and forward facilities of the State Bank
	• U.S. branch banks accorded full national treatment
December 10, 2010	• 100% U.S. subsidiary banks allowed

Having been prohibited from taking domestic currency (dong) deposits or setting up a network of branches, the foreign branch banks have confined their business mainly to trade finance and providing banking services to multinational corporations. It is expected, however, that as the restrictions on foreign bank operations are eased, they will increase their share of the market and pose a competitive challenge to both the SOCBs and joint-stock banks.

In assessing what Vietnam can learn from other developing countries, it is useful to note that Vietnam's commitments under the BTA are not significantly different from those of other developing countries that have recently acceded to the WTO. Nor is Vietnam unique among developing countries in terms of the weakness of its financial sector in general and banking system in particular. A policy of "financial repression"—interest rate ceilings, policy-based lending, high reserve requirements, and other measures that help finance government spending while undermining the efficiency of the banking system—was (and still is, albeit to lesser extent) commonplace in developing countries. However, with the rapid integration of international financial markets and the expansion of the WTO mandate to encompass trade in financial services, many developing countries have accelerated financial sector liberalization and opened their banking sectors to foreign competition. We now review briefly the evidence on the impact of foreign bank entry in Turkey, Colombia, and Argentina.

Turkey

In the wake of a severe macroeconomic crisis, Turkey launched a sweeping financial sector liberalization program in 1980 (Onis and Riedel 1993). Until then, Turkey had employed all the elements of financial repression in its pursuit of a state-led, import-substitution industrialization strategy—interest rates were controlled, reserve requirements were high, and state-directed credit allocation was pervasive, accounting for about 75 percent of bank loans. As a result, in the 1960s and 1970s, a large number of banks exited the market and the system became highly concentrated in the hands of a few private and state-owned commercial banks with extensive branch networks.[34]

During the 1980's, financial liberalization in Turkey led to the entry of a significant number of banks, both domestic and foreign, with the latter increasing from 4 to 23. Denizer (2000) suggests that the entry of foreign banks after 1980 was motivated largely by the expansion of foreign trade consequent on a concurrent liberalization of trade policy. Foreign banks, he argues, perceived a strong comparative advantage in trade finance and moved aggressively into the niche of the market. In the Turkish case, foreign bank entry did not lead to a significant increase in the foreign-bank share of assets and liabilities in the banking system because the foreign banks specialized in fee-based trade finance, corporate finance, and trading in derivatives, leaving much of domestic retail lending market to domestic banks with large branch networks (Denizer 2000: 15).

Denizer undertakes an econometric analysis of the Turkish banking sector to test the hypothesis that foreign bank entry contributes to increasing efficiency as evidenced by lower interest margins and overhead costs. He concludes that "foreign bank entry had a strong competitive effect in Turkey despite the fact that the scale of their operations has been small" (Denizer 2000: 19). As in the cross-country studies, in Turkey increasing penetration by foreign banks led to lower interest margins and overhead costs, as well as declining profit margins among domestic banks. Foreign banks also contributed to financial development by inducing better bank management practices among domestic banks. After 1980, "Turkish banks imitated foreign banks adopting planning, budgeting and modern management information systems" (p. 17). When foreign banks began marketing their services to Turkish blue chip companies, local banks were forced to set up their own marketing units.

Colombia

For more than 50 years, Colombia allowed foreign banks unfettered access to the domestic banking market. This came to an end in 1969 when, in the midst of a macroeconomic crisis, Colombia began to close the domestic market to foreign banks and subsequently implemented laws that required existing foreign banks to transform themselves into minority joint ventures. A decade later, in the early 1980s, Colombia found itself again mired in a financial crisis, which became the motivation for sweeping financial sector reform, this time in the direction of liberalization. Beginning in 1985, Colombia began to liberalize its financial system, introducing deposit insurance, a loan guarantee fund, and the re-privatization of banks that had previously been nationalized (Barajas et al. 1999). In 1990, Colombia began to eliminate restrictions on foreign bank entry and granted national treatment to foreign banks. As a result, over the period from 1991 to 1998, foreign banks increased their share of total bank assets from 7 to 31 percent, while at the same time state-owned banks' share of assets fell from 55 to 10 percent in 1998 (Barajas et al. 1999: 13).

The increase in foreign bank entry after 1990 had many of the beneficial effects on the banking system that cross-country studies have found. Barajas et al. (1999) provide econometric evidence that foreign bank entry intensified competition in the banking market, with the effect of lower interest margins and overhead costs. Interestingly, this study finds that increased entry of domestic banks following the 1990s financial liberalization had even greater impact on competition and efficiency than

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[34] The proliferation of branches was a direct result of financial repression, since no other means of competition was permitted in the system.

increased foreign bank entry. Indeed, the entry of new domestic banks after 1990 is shown to have led, through increased competition, to increased efficiency among foreign-owned banks in Colombia. The only negative impact from increased foreign bank entry in the Colombia case was an observed decline in loan quality among domestic banks, which could have been the result of increased competition and lower interest margins or the flight of higher-quality borrowers from domestic to foreign banks (Barajas et al. 1999: 37).

Argentina

After a long period of hyperinflation and financial disintermediation, Argentina, in 1991, pegged its currency to the dollar and dramatically reduced its inflation rate. Thereafter, the country experienced a rapid growth in financial deepening (e.g., as measured by the ratio of M2 to GDP). Particularly noteworthy was a period of intense foreign bank entry in the mid-1990s. Clarke et al. (1999) analyze the impact of foreign bank entry during this period on the performance of domestic banks. Like most of the other studies reviewed here, they find that foreign bank entry intensified competition and improved efficiency. However, what is notable about the Argentina case is that the impact of foreign competition was confined to those sectors in which foreign banks have a comparative advantage and where they focused their lending—in the case of Argentina, mainly in manufacturing and mortgage lending. In areas where domestic banks have a traditional comparative advantage—for example, retail banking and consumer lending—foreign bank entry appeared to have no effect on efficiency.

Conclusion with respect to the liberalization of foreign bank entry in Vietnam and other developing countries

Many countries that have undertaken aggressive financial liberalization in recent years, including opening up the banking sector to foreign competition, started from an unfavorable position of severe financial repression. In this respect, Vietnam is by no means unique. Nevertheless, domestic banks have, by and large, survived and prospered in the face of increased foreign competition. In our review of econometric evidence (Section 6.2) and country experiences we have focused on four issues regarding the impact of foreign bank entry: (i) competition and efficiency; (ii) banking sector stability; (iii) the allocation of credit across sectors of the economy; and (iv) the development of domestic banks. The evidence overwhelmingly suggests that, on balance, foreign bank entry is a positive force in regard to each of these issues.

First, foreign bank entry intensifies competition in the local banking market and provides incentives for domestic banks to become more efficient. Although the profitability of domestic banks may suffer from increased foreign competition, consumers of banking services and the economy as a whole benefit from greater access to credit and better terms of borrowing. Consistent with the theory of contestable markets, this may be true even when foreign banks' share of the domestic banking market is quite small.

Second, although financial crises were often preceded by financial liberalization, the experiences of financial crises in Latin America and East Asia suggest that foreign bank entry has stabilized domestic banking. Foreign banks in developing countries have more diversified portfolios and greater access to funds around the world through their parent companies; therefore, they are less exposed to risk and less affected by crises in the host country. In the Latin American countries that experienced financial crises in the 1990s, foreign banks exhibited stronger growth and less volatility in their lending during crises and immediately thereafter. In the East Asian financial crisis, foreign banks took less risk leading up to the crisis and survived the crisis in better shape than their domestic competitors.

Third, foreign bank entry has tended to improve, or at least has not harmed, the access to credit of small and medium-size companies. While foreign banks tend to serve mainly larger borrowers, their impact on competition served to improve the access to credit and the terms of borrowing of smaller companies.

Fourth, foreign banks in developing countries followed their comparative advantage, concentrating their activities in certain banking niches (eg., trade finance and derivatives) and certain branches of the economy (manufacturing), leaving domestic banks to expand in the areas of their own comparative advantage, namely retail banking, consumer credit, and lending to small and medium-size companies. Even in countries that began with fragile and inefficient domestic banking systems, local banks have survived and expanded in the face of increased competition from foreign banks.

Finally, while foreign bank entry is generally beneficial even in countries with weak and fragile banking systems, it is only one, and not necessarily the most important, component of financial liberalization. It does not relieve governments of the financial burden of restructuring state-owned banks, which may be difficult and expensive because of their links with state-owned enterprises. Nor can governments afford to ignore the problems of domestic private banks which frequently suffer from entry and activity restrictions that undermine their competitiveness and efficiency. What the various country experiences show is that liberalizing foreign bank entry rapidly—whether unilaterally under pressure from a macroeconomic crisis, under a bilateral agreement like Vietnam, or under the GATS—can provide an impetus for a broad-based financial liberalization with multiple benefits.

7 Prospects for Developing Country Service Exports

7.1 Modes 1 and 2

Although developing country service exports have grown considerably since the mid-1990s, their performance has been less than spectacular compared with goods exports; their composition by broad categories of services has also changed only little. Data from the IMF's Balance of Payments Statistics (i.e., limited to Modes 1 and 2; i.e. cross-border supply and consumption abroad)) are available only from 1995 through 2001 (Table 7.1).[35] During this period, developing country service exports grew by 25 percent whereas goods exports grew by 35 percent.[36] As for the composition of service exports, transportation accounted for around one-quarter of service export earnings while travel and "other" services each contributed a little more than one-third. The latter category includes a wide variety of sectors such as communications, construction, insurance, financial, computer and information, royalties and license fees, other business services, personal, cultural, and recreational services. Many of these are nontraditional exports that have recently received considerable attention in academic as well as policy circles.

There is little evidence that import barriers constitute a bottleneck for many types of developing country service exports under Modes 1 and 2. In maritime transport services, some vestiges of bilateral, intergovernmental cargo-sharing agreements appear to persist but have little impact on market outcomes (WTO document S/C/W/62 of 16 November 1998). In travel and tourism, developing country exports occur mainly through Mode 2 (consumption in developing countries by residents of high-

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[35] A more detailed discussion of data availability and trends in service trade is found in Langhammer (2002) and BMZ (2003). As regards data quality, it is very likely that balance of payments data underestimate the level of international trade in services even under Modes 1 and 2. However, there is no hard evidence (nor even a plausible argument) that the growth rate of services is also underestimated. It is not quite clear how service trade under Mode 3 should be measured appropriately; services sold by foreign-owned suppliers but produced domestically are conceptually different, for instance, from services imported across the border (Mode 1). Furthermore, data on service trade derived from international payments flows relate only to "disembodied" services, not to services partly embodied in internationally traded goods where some portion of customs value reflects the cost of embodied services.

[36] It is worth noting that some goods exports of developing countries, particularly textiles and clothing, benefited from Uruguay Round import liberalization in high-income countries during this period.

Table 7.1:
Service Exports by Developing Countries, 1995 and 2001

	1995	2001
All commercial services (U.S.$ bn)	322	402
Of which (in percent)		
Transportation	26.6	25.5
Travel	36.6	38.1
Other commercial services	36.8	36.5
Memorandum items:		
Developing country goods exports	1,661	2,245
Industrialized country commercial services exports	854	1,040

Source: IMF, various issues of *Balance of Payments Statistics.*

income countries) and face no significant trade barriers on the part of high-income countries.[37] Import barriers are also (still) relatively unimportant for many nontraditional service exports that are of particular interest to developing countries, such as data processing and information technology services, as WTO members have so far refrained from levying customs duties on electronic transmissions (e-commerce moratorium).[38]

The modest growth of both traditional and nontraditional service exports by developing countries overall contrasts with the high expectations that surround many academic discussions and the public debate on this topic. It is useful, therefore, to look more carefully at the experience of one frequently mentioned example of a successful service exporter, India (Table 7.2). India's exports of "other business services," which include information technology and data processing, shot up from U.S.$2.3 billion as late as 1995 to U.S.$18.6 billion in 2002.[39] In absolute terms, the increase was almost as large as the increase in goods exports during the same period; thus, services contributed significantly to the increase in the ratio of India's total exports to GDP. The growth of service exports remains remarkable even though *imports* of "other business services" (some of which are probably inputs into the production of service exports) also increased sharply at the same time. Why then was India so much more successful as a service exporter, specifically in information technology and data processing, than most other countries?

Some clues are provided by OECD (2003b) who analyzes the determinants of developing country service exports in a wide variety of sectors, both traditional and other. Most of the discussion, part of which is contained in the supporting unpublished working document (TD/TC/WP(2003)23), dwells on case studies and other anecdotal evidence because little comprehensive data appears to be available at a sufficiently disaggregated level. The paper distills the following lessons from the evidence:

- Developing countries are significant players only in a small number of markets, including port and shipping services, audiovisual services, construction, health, and data processing. These are mostly still low-skilled-labor-intensive services, at least by the standards of high-income countries. Exports

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[37] However, some restrictions on FDI in developing country tourism sectors may have the effect of holding back tourism development rather than increasing the total value added retained by developing country residents. Similarly, the protection of transport-related (e.g., port) services in many developing countries probably represents a substantial barrier to other exports and unnecessarily drives up import prices.

[38] Certification requirements may represent an effective trade barrier for some developing country service suppliers; for example, health care providers in developing countries may find it difficult to collect payments from insurance companies in high-income countries. Also, note that the e-commerce moratorium formally expired at the time of the Cancun Ministerial and its future now appears somewhat uncertain (see our comments further below on the recent public debate in the United States on how the outsourcing of back-office operations impacts skilled employment).

[39] For more detailed information on the sector, see Arora et al. (2001)

at higher skill levels are a recent phenomenon, driven by the much lower wages for high-skilled labor in developing vs. high-income economies.

Table 7.2:
India: Exports of Commercial Services, 1995–2002 (in U.S.$ billion)

	1995	2002
All commercial services	6.8	24.6
Transportation	1.9	2.5
Travel	2.6	3.0
Other services	2.3	19.0
Insurance	0.2	0.4
Royalties and license fees	0.0	0.0
Other business services	2.1	18.6
Memorandum items:		
Imports of other business services	–2.7	–11.8
Goods exports	31.2	52.7
Exports of goods and services (percent share in GDP)	10.4	13.7

Source: IMF, various issues of *Balance of Payments Statistics.*

- For many nontraditional services, electronic supply across borders and hence access to high-quality telecommunications infrastructure are crucial for the competitiveness of developing country service providers.
- A large domestic market is often a springboard, first, for exports to countries that are geographically or culturally close, and then to exports farther afield.

In the case of India, it appears that several favorable factors have combined to render exports of electronic services attractive. Extensive government financing of higher education has helped to produce a large number of graduates, especially in the natural sciences and mathematics, who are highly proficient in the English language. At the same time, the foreign-currency wages of Indian university graduates are low even compared to low-to-medium skilled workers in industrialized countries. The telecommunications infrastructure in India, at least in the regions where service exports originate, is in good working condition while the policy regime for international trade has been liberalized considerably since the 1990s. As a result, Indian companies have become viable exporters of a range of electronic services from programming to data processing and call center operation, most of which are expected to benefit from growing world-wide demand for some time yet.[40]

It is not clear how many countries can expect (or should even try) to replicate the Indian experience. First, in terms of reducing poverty, extensive government subsidies for higher education may not represent the best possible use of scarce resources; very likely, higher expenditures on primary education would be more effective. Second, while electronic services have benefited from increasing global demand, demand for some low-skill-intensive services (where skill intensity is defined relative to the labor force in high-income countries) may well decline due to further technological change; for example, improved voice recognition software could render various data processing operations redundant. Third, there are simply not many developing countries with English as the main language of communication, a sufficiently sophisticated physical infrastructure, a workable business environment, and an ample supply of university graduates at very low wages.

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[40] It is worth noting that up to 60 percent of India's software exports reportedly still involve onsite input, i.e., Indian programmers visiting importers under Mode 4 (Mattoo 2003: 5).

At the same time, the market for outsourced back-office work as well as higher-skilled IT services is still growing rapidly. It is therefore likely that many developing country exporters will establish themselves in particular market segments, though at a more modest scale than Indian firms. Recent anecdotal evidence relates to various electronically transmitted service exports from Ghana, the Philippines, and China. At the same time, however, developing country service exports will have to grow substantially faster than in the recent past to even keep pace with goods exports.

Export prospects for developing countries will be strongly influenced by the future service import regimes of industrial countries. In the United States, a public debate has recently begun on the employment and wage effects of IT outsourcing, particularly with respect to higher-skilled employees. This debate has included calls for protective measures, such as limiting U.S. government contracts to firms that perform certain back-office operations in the United States. While it would be premature at this point (Spring 2004) to speculate on how this debate will play out in the heat of the U.S. presidential election campaign until November 2004, it is worth remembering that recently implemented or proposed protectionist measures against certain goods imports (e.g., steel, textiles) were largely driven by political expediency. Against this background, it is not clear that developing countries are well-advised to reject negotiations on government procurement during the Doha Development Round, either regarding the transparency of government procurement generally (one of the Singapore topics) or market access or national treatment issues in government procurement in services specifically (cf. the negotiating mandate of GATS Art. XIII).

On balance, then, developing country service exports are most likely to continue to grow modestly along the recent trend. While high-income country import barriers, such as registration and certification requirements for health care providers, are probably holding back some developing country exports, they are not yet a *major* concern (compared, say, to developing country exports of temperate-zone agricultural products or textiles). A formal extension of the e-commerce moratorium in the near future would provide a welcome signal that the international trading environment for IT services will remain open. In any case, the benefits to developing countries from higher service exports under Mode 1 or 2 pale in comparison to the potential benefits from significant improvements under Mode 4 (temporary presence of natural persons; see Section 7.2). High-income countries will find it difficult, therefore, to defuse the politically charged issue of improving market access under Mode 4 by offering wider access under Modes 1 or 2.

7.2 Mode 4

Unfortunately, the GATS definition of Mode 4 service trade is not very specific on what movements by people across borders are to be covered. Art. I(2)(d) of the GATS defines Mode 4 as supply "by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member." The "Marrakesh Annex on movement of natural persons supplying services under the Agreement" excludes from the coverage of the GATS "measures affecting natural persons seeking access to the employment market of a Member" as well as "measures regarding citizenship, residence or employment on a permanent basis." While this provision precludes the GATS from applying to individuals seeking dependent employment in another WTO member country at a domestically owned company, there is a wide variety of institutional arrangements short of permanent immigration that could potentially be covered under Mode 4.

The negotiating interests of developing and industrial countries differ substantially in this area. Industrial countries seek more flexibility for multinational companies regarding staff deployment around the world; such expatriate positions are normally permanent and individual staff remain in a given country for several years at a time. Developing countries are interested mainly in enhanced work opportunities for their nationals in high-income countries across the whole spectrum from short-term

business visits (which in practice are subject to visa problems in many industrial countries) to work opportunities for developing country nationals in industrial countries for periods of up to several years. It is worth noting that the concerns of neither industrial nor developing country governments are limited to service trade in a narrow GATS sense. The deployment of expatriate staff is an important issue for multinational companies in any sector of the economy, and similarly the benefits to developing countries from enhanced work opportunities in industrial countries do not depend on the sector in which their nationals work.

In principle, the economic effects of "temporary presence" of service suppliers in importing countries are similar to outright immigration. The effective supply of workers with particular skills (depending on who is admitted) is expanded; hence, their relative wage will decline. At the same time, the productivity of other inputs (other categories of workers, physical capital, real estate, etc.) and hence their remuneration tend to increase. On balance, the overall income and welfare effect for host country residents will normally be positive, unless there are negative external effects or immobile factors of production are largely owned by nonresidents.[41] However, a strong distributional effect is likely to fall on low-to-medium-skilled workers who would be the most likely group to face competition from temporary immigrants (assuming that temporary immigration reaches economically meaningful proportions). Hence the wide-spread political resistance to immigration, temporary (such as under Mode 4) or otherwise.

From the point of view of migrants' home countries, there is some concern that even temporary migration may involve a brain drain, especially when education is government-financed. This concern is counterbalanced by the insight that very many migrants ultimately return to their home countries and benefit from the human capital as well as financial savings accumulated abroad. The main effect, therefore, is that individuals from a low-income country are able to earn much higher wages in a high-income country, increasing residents' average disposable income.[42] Typically, migrants' remittances benefit a relatively large number of individuals through extended family links.

The existing estimates of income gains to developing countries from permitting even small labor movements are huge because the income gains that result from international trade in goods or factor services rise with the square of the price differentials in national markets (Rodrik 2002). Whereas the remaining price differentials for goods are rarely above 2 to 1, the wages of similarly qualified individuals in high-income and low-income countries can easily differ by a factor of 10. Rodrik (2002) reports a back-of-the-envelope calculation for a hypothetical visa scheme that would allow revolving immigration into high-income countries in the amount of 3 percent of their labor force for 3-to-5-year periods. The income gains for developing country residents could easily be in the order of U.S.$200 billion per year, much more than the estimated income gains from other types of trade liberalization (UNDP 1992 had a very similar estimate). Winters et al. (2002) report similarly large income gains based on much more elaborate simulations based on the GTAP global computable general equilibrium

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[41] In addition, Davis and Weinstein (2002) point out that if the destination country is technologically superior to the migrants' country of origin, the natives may lose from immigration because their terms of trade deteriorate (intuitively speaking, they have to share the benefits of working under superior technology with the immigrants). In this context, technology is defined in relation to a macroeconomic production function and therefore includes such factors as the quality of social institutions (i.e., anything that allows a country to produce more GDP from a given combination of factor inputs: land, physical capital, and labor of various skill levels). Even then, world income will still increase because of the global division of labor is enhanced.

[42] This point may be more obvious to noneconomists than to economists who are brought up on a diet of Heckscher–Ohlin–Samuelson trade theory with its factor price equalization theorem (which, naively stated, says that international trade in goods equalizes relative factor prices even without international factor movements). For economists, the point to note is that even if physical capital is internationally mobile, other factor endowments, especially human capital, are so unequally distributed that countries become completely specialized, producing only a subset of goods in which they have a comparative advantage. As a consequence, factor prices are not equalized across countries (even though they are less unequal than they would be in the absence of international trade). The extremely unequal distribution of human capital may be compounded by technological differences (see the previous footnote).

model. The examples of several small countries where favorable cultural and geographic factors combine to permit large-scale labor emigration (legal or otherwise) confirm the potentially large income gains. Both in the Philippines and in Moldova, migrant remittances amount to between 10 and 20 percent of GDP. While Philippine nationals constitute a major proportion of the crews of merchant ships world-wide, many Moldovans have found access to the Italian and Portuguese labor markets (mostly illegally) because their Romanian language permits them to communicate in those countries.

It must be noted that labor migration as simulated (Rodrik 2002; Winters et al. 2002) or observed (Philippines, Moldova) is not limited to the provision of services in accordance with the GATS. Migrants are typically employed in a wide range of low-skill-intensive activities, including in manufacturing and agriculture. Therefore, in an ideal world, the GATS with its limited focus on service trade (or even the WTO more generally) might not be the most appropriate environment to negotiate and implement rules for international migration, temporary or otherwise. Politically, however, the Doha Round GATS negotiations on Mode 4 trade appear to offer the best opportunity presently available to developing countries to press for more liberal access to industrial country labor markets. Winters et al. (2002) and Mattoo and Carzaniga (2003) discuss options for feasible institutional arrangements that could become the basis of negotiations.

8 Conclusions

8.1 Implications for Developing Countries' Positions in GATS Negotiations

This section draws together the implications of the foregoing discussion for developing countries' positions in post-Cancun negotiations on trade in services.[43] There are two main questions to be answered: First, what liberalization measures should developing countries offer to commit to, in response to the requests from trading partners? Second, what measures by high-income countries should developing countries push for, given the formers' initial offers?

Since 2002, several countries have sent requests for commitments on services to a large number of trading partners, including developing countries. Although most such requests are not in the public domain, the EU did publish an official summary and all individual EU requests are now available from the website of a Canadian NGO (www.polarisinstitute.org). They cover a large number of sectors, including some that involve network-based monopolies such as water services (under the heading of environmental services). As discussed above, developing countries should respond to these requests based on their own priorities for liberalizing service imports. As part of this approach, they may wish to refrain from making commitments for sectors where their own policies have not yet been defined or where import liberalization would not demonstrably enhance competition.

Regarding market access for developing country service exports to high-income countries, Section 7.2 has demonstrated that the main potential source of income gains for developing countries would be measures under Mode 4 (temporary presence of natural persons). Unfortunately, the initial offers by several large high-income countries, including the United States, the European Union, and Japan, are rather restrictive in this regard (WTO documents TN/S/O/[country name]). Proposed commitments tend to be limited to the movement of managers (especially as part of intrafirm transfers) and technical specialists. Given the huge potential gains, compared with any other possible "concessions" by high-income countries, developing countries may wish to consider a major initiative to start serious

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[43] It is reassuring to note that many developing countries are actively involved in shaping the direction of discussions in the Council for Trade in Services, judging by their frequent communications to Council members: http://www.wto.org/english/tratop_e/serv_e/s_propnewnegs_e.htm

negotiations on this point. In addition, on a country-by-country and sector-by-sector level, they may be able to address critical import barriers that hold back their exports under Modes 1 or 2.

8.2 Implications for Technical Assistance and Donor Policies

The potential contribution of technical assistance (TA) and the role of donor policies naturally differ across the various policy areas covered by this report. With respect to service imports, liberalization will only be successful if it is "owned" by developing country governments and enjoys broad domestic political support. This may require the building of coalitions that are strong enough to counter the special interests opposed to reform. Technical assistance may be able to support the policy-making process through appropriate policy dialog, such as with the dissemination of knowledge on international best practices of sectoral regulation, expert-level training, etc. Since in this context "one good example is worth more than a thousand words," it may often be useful to focus the policy dialogue on the reform experiences (good or other) of both high-income and developing countries.

Closer to the definition of specific policies, TA may support capacity building and analytical work at the country level to identify priorities for sectoral reform and import liberalization as well as quantify the potential welfare gains and ensuing structural change. Frequently, sectoral reform and import liberalization will be closely interdependent and will need to be approached simultaneously, both at the analytical level and in the policy-making process. Very often, once a sector has been identified as a target for reform, the emphasis will be on devising a comprehensive sectoral policy in conjunction with other major donors, such as the World Bank and other development banks. While some developing countries have the financial resources and expertise to play a leading role in this task, frequently it will be helpful to involve international experts in policy formulation, especially with a view to ensuring that the outcome reflects international best practice.

The actual implementation of sectoral reforms is frequently supported by donor loans or grants, especially when reforms involve the restructuring of state enterprises. While development banks have often taken the lead in providing such loans, there will be opportunities for bilateral cofinancing. One area of implementation that frequently requires long-term external support is government regulation of newly reformed sectors. The precise format—a competition authority spanning several sectors, an independent sector-specific authority, direct supervision by the competent ministry—will depend on the size of the sector, the country's level of development, the degree of state capture by private interests, the complexity of the regulation, etc. In any case, the success of reforms very often hinges on effective post-reform regulation that ensures that monopoly power (e.g., due to networks) is not abused and that, where feasible, competition is maintained.

Regarding potential developing country service exports under Modes 1 and 2 (cross-border supply and consumption abroad), TA may help by providing analysis of the development potential of individual sectors along with the identification of any bottlenecks that are holding back exports, such as high-income country trade barriers, limited access to crucial inputs at competitive prices, etc. While of limited importance overall, the elimination of import barriers in high-income countries could have important sectoral effects, with significant benefits for consumers in high-income countries. For example, reforms in health care provision in high-income countries may create incentives for imports from developing countries, especially if copayments become more wide-spread and insurance payments are fixed per case rather than linked to expenses incurred by the providers.

As with manufactured exports, export promotion financed by national governments or donors may often be justified for promising service sectors: "pioneer exporters" incur significant costs when they enter a nontraditional export market, while imitators can build upon the pioneers' experiences and therefore face lower fixed costs of market entry. As a result, exports may not occur in the absence of coordination among exporters. In this case, export promotion measures can reduce the costs of market

entry so that instead of the pioneer bearing a large initial cost for the benefit of its imitators, taxpayers (or donors) bear the extra cost while economic agents at large (presumably) reap the benefits of higher and more diversified exports.

Finally, with Mode 4 exports (temporary presence of foreign service providers) promising by far the largest potential welfare gains for developing countries of all the policy areas discussed in this report, any improvements in access for temporary workers from developing countries particularly in high-income countries would be most welcome. While this will obviously represent a substantial political challenge for high-income-country governments, the extent to which they meet this challenge will widely be seen as a test of their sincerity in promoting open borders, economic growth in developing countries, and last but not least progress towards the Millenium Development Goals.

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