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THE EXPERIENCE WITH LIBERALIZATION OF TRADE AND FOREIGN DIRECT INVESTMENT IN SERVICES

by

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I. Introduction*

Liberalization in service markets has received increased attention in recent years. Above all, the ongoing GATT negotiations of the Uruguay-Round are stimulating the discussion. Yet the number of countries which have adopted a deregulation approach to services is limited. And little attention has been paid to the experience of developing countries in this area. In common perception liberalizing international transactions in services is a North-South-issue with expected gains from trade for industrial countries at the expense of the developing world (see, e.g. Sapir, 1985; Randhawa, 1987). But also within industrial countries many concerns are brought forward - notably by well established producers on sheltered domestic markets. On the other hand, some developing countries are increasingly aware of the potential contribution of services for the improvement of their overall export performance and current accounts.

In the following, an attempt is made to reveal the impact of government regulations on international transactions in services and to evaluate the opportunities of developing countries in open service markets. In the first section, some global trends and theoretical considerations on international trade and foreign direct investments in services are presented. In the second section the nature and significance of government regulations in different service industries are discussed. The final section provides some tentative conclusions from the experience of those countries that recently deregulated particular service industries.

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[1] The author is grateful to Rolf J. Langhammer for many helpful comments.

II. Transaction costs and international trade in services

The importance of services in international trade is less pronounced than in production. Services account for about 50 percent of world output (table 1)), whereas their share in world exports is less than 20 percent[1]. Presumably, the comparably low exposure to international competition is primarily caused by the existence of substantial transaction costs associated with transborder flows of services (Rugman, 1986). Such costs may result from specific production techniques and/or policy measures affecting international trade. With respect to the first type, the whole service sector could be divided into three groups (Bhagwati, 1987):

- In the first group, consumers move to producers in order to receive the offered service. Personal services and retail trade are examples (mobile user, immobile provider).

- In the second group, producing the respective services in associated with a spatial movement of the producer to the consumer. This mainly applies to the whole transport sector (mobile provider, immobile user).

- In the final group no direct contacts between producers and consumers and no spatial movements of persons are required. These movements are substituted by transborder flows of information. Examples are given by telecommunications or financial services (physical proximity inessential).

According to Bhagwati (1984), activities of the first two groups might be referred to as "embodied" services, whereas

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[1] Here and in the following, "investment income", and "official goods services and income" are excluded from total trade in services. The analysis concentrates, therefore, mainly on services produced by business enterprises. Corresponding to most other studies construction is not treated as service industry.

Table 1 - GDP structure of production 1973-1986 (percent)

Year	Industrial market economies			Developing countries		
	Agri-culture	Industry	Services	Agri-culture	Industry	Services
1965	5	40	55	29	29	42
1973	5	38	57	24	32	44
1979	3	37	60	19	37	44
1985	3	36	61	19	34	47
1986	3	36	61	18	34	48

Source:: World Bank (various issues); own calculation.

those of the third group are "disembodied" ones[1]. No doubt, the border lines between these three categories are somewhat arbitrary and perhaps changing over time. Nevertheless, they allow to classify different types of services with consideration of transaction costs in international trade.

Apparently, transaction costs are extremely high in the first group. As a consequence, international trade in personal services, e.g., is quite unimportant. In the second group there are many opportunities of reducing transaction costs by increasing capital-intensity of production. There are much more economies of scale to be exploited in transport services than in personal services. Now and then, these capital-intensive services are labelled as "smokestack services" (Aronson, Cowhey, 1984). In the group of disembodied services, finally, transaction costs are mainly determined by the availability of information and communication technologies. Due to rapid technical progress in microelectronics transaction costs in trading disembodied services nowadays often are even lower than transaction costs in merchandise trade.

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[1] In Bhagwati (1987) disembodied services are denoted as "long-distance services".

Moreover, decreasing information and communication costs give rise to a shift of production techniques. Notably in business services telephone calls and other forms of electronic communication are increasingly substituting personal talks. By means of this process of "disembodiment" (Bhagwati, 1984) there is a continuous transition from embodied to disembodied production techniques in the service sector.

Due to comparably low transaction costs substantial international trade flows could occur in disembodied services and in capital-intensive embodied services as well. Only in labour-intensive embodied services tradeability seems to be quite low (table 2). Subsequently, international trade in

Table 2 - International tradeability of different types of services

Service industry	Production technique		Capital intensity			International tradeability	
	Embodied	Disembodied	High	Medium	Low	High	Low
Wholesale and retail trade	x				x		x
Maritime transport	x		x			x	
Air transport	x		x			x	
Other transport	x			x		(x)	
Communication		x	x			x	
Financial institutions		x		x		x	
Insurance		x		x		x	
Business services		x			x	x	
Community, social and personal services	x				x		x

services concentrates on transport (with the exception of local transport, which is included in "other transport"), communication, banking, insurance, and business services.

As a result of the growing importance of services in world output and of the ongoing process of disembodiment within the service sector it should be expected, that the growth rates of service exports would exceed those of merchandise exports. As a matter of fact, however, the share of services in world exports decreased in the seventies, whereas in the eighties exports of services just kept pace with exports of goods (table 3)[1].

Within the service sector, the development of international trade was somewhat distinct[2]:

- The share of labour-intensive embodied services (travel) in world trade was reduced in the seventies and remained stable in the eighties.

- The share of capital-intensive embodied services (transport) was decreasing over the whole period.

- Disembodied services (other private services) is the only category that shows a slightly increasing share in both sub-periods.

All in all, the trade performance of services as compared to merchandise trade is disappointing. The comparably low level of service exports may be explained by remaining differences in transaction costs; the low rate of export growth, however, is in contradiction to the growing share of services

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[1] In order to avoid distortions from cyclical fluctuations peaks of the business cycle were chosen as benchmark-years.

[2] For a definition of different service categories in balance of payments statistics see IMF (a).

Table 3 - World trade by type of goods and services and region 1973-1985

	1973		1979		1985	
	Bill. SDR	p.c.	Bill. SDR	p.c.	Bill. SDR	p.c.
World						
Merchandise	412.3	81.6	1157.0	82.6	1732.6	82.6
Services(a)	93.0	18.4	243.4	17.4	365.9	17.4
Travel	27.7	5.5	65.8	4.7	97.6	4.6
Transport	35.0	6.9	85.7	6.1	123.0	5.9
Shipment(b)	16.7	3.3	38.5	2.7	53.2	2.5
Other transport	18.3	3.6	47.2	3.4	69.8	3.4
Other private services(c)	30.3	6.0	91.9	6.6	145.3	6.9
T o t a l	505.3	100.0	14004.0	100.0	2098.5	100.0
Industrial countries						
Merchandise	315.7	81.1	793.8	80.8	1213.0	81.8
Services(a)	73.6	18.9	181.1	19.2	269.7	18.2
Travel	20.6	5.3	47.0	4.8	69.8	4.7
Transport	29.0	7.4	68.5	7.0	94.0	6.4
Shipment(b)	14.8	3.8	32.6	3.3	42.3	2.9
Other transport	14.2	3.6	35.9	3.7	51.7	3.5
Other private services(c)	24.0	6.2	72.6	7.4	105.9	7.1
T o t a l	389.3	100.0	981.9	100.0	1482.7	100.0
Developing countries						
Merchandise	96.6	83.3	363.2	86.8	519.6	84.4
Services(a)	19.4	16.7	55.3	13.2	96.3	15.6
Travel	7.1	6.1	18.8	4.5	27.8	4.5
Transport	6.0	5.2	17.2	4.1	29.1	4.7
Shipment(b)	1.9	1.6	5.9	1.4	10.9	1.8
Other transport	4.1	3.5	11.3	2.7	18.2	2.9
Other private services(c)	6.3	5.4	19.3	4.6	39.4	6.4
T o t a l	116.0	100.0	418.5	100.0	615.9	100.0

(a) Excluding investment income, other official goods, services and income. - (b) Including freight insurance. - (c) Including other private goods and income.

Source: IMF (b); own calculations.

in output and the process of disembodiment within the service sector. It has to be explained, therefore, by artificial barriers to trade, especially by the existence of government regulations in service markets. The discrepancies between potential and actual export growth of services point out, that these barriers are affecting the export opportunities of industrial countries and developing countries as well.

Several attempts have been made to evaluate the potential outcome of international trade in services under the regime of liberalized world markets. Those studies point out, in general, that there is no systematic difference in trading goods and trading services. In other words, the Ricardo-theorem of comparative costs would also apply to services (for a summary of this discussion see Deardorff, 1984; Stern, 1984; Krommenacker, 1984). A Heckscher-Ohlin model of international trade would predict, therefore, a comparative advantage and a corresponding trade-surplus of industrial countries in human-capital intensive services, whereas developing countries would specialize on labour intensive and perhaps on physical-capital intensive services[1].

In fact, however, international trade is not dominated by such inter-industry patterns, but by intra-industry trade. Nowadays, a substantial part of international trade is a two-way road even within single product categories. This

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[1] A sustainable comparative advantage of a country might be etablished only by the endowment with comparably immobile production factors (Leamer, 1984, p. 22). While unskilled labour and human capital might be regarded, by and large, as immobile factors, physical capital has proved to be a factor of high international mobility. In consequence, capital-intensity of exports could not be explained by the endowment of countries with physical capital (Leontief-paradox), but by international differences in rates of return and, more important, by production complementarities between physical capital and unskilled labour. For an estimate of factor intensities of U.S. multinationals exports of goods and services see Kravis, Lipsey (1986).

increasingly applies to north-south trade as well, which primarily consisted of inter-industry trade relations in the past. It might be expected, hence, that a world-wide deregulation approach to services would bring about an increase of intra-industry trade in services. As a consequence, both imports and exports of services would probably be higher in industrial countries and developing countries as well (Schott, Mazza, 1986).

III. Nature and significance of regulations in services

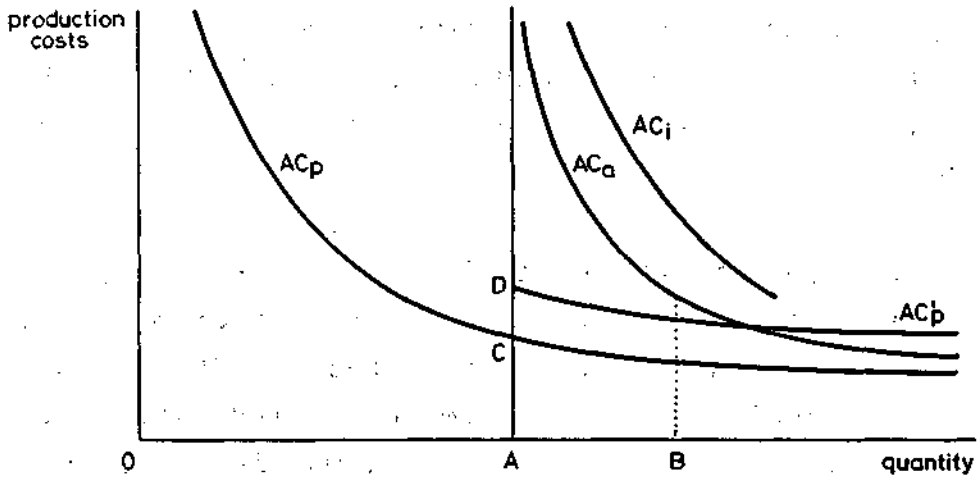
1. A model of regulation, international trade and foreign direct investment

Before entering into details of government regulations in different service industries it seems appropriate to analyse the impact of regulations on international transactions in the context of modern trade theory. A graphical illustration could help to explain the decisive points of such an approach.

In figure 1 the left-hand side and the right-hand side represent two markets for one product in different countries. It is assumed that the total costs of production consist of constant marginal costs, plant-specific fixed costs and some additional fixed costs, which are enterprise-specific but not plant-specific (brand name, R&D etc.). Thus, average cost-curves are downward sloping. In addition, production technology is assumed to be ubiquitous.

The company facing the cost-curve AC_p, hereafter called the parent company, is selling the quantity OA on its home market. The cost-curve of a foreign affiliate (AC_c) runs below the cost-curves of independent companies (AC_i), since the affiliate does not carry the burden of enterprise-specific fixed costs. It is assumed that there are not substantial additional costs of supervising production abroad which pro-

Figure 1 - Production costs of parent company, foreign affiliate and independent competitor



AC_p - average costs of parent company
AC_a - average costs of foreign affiliate
AC_p' - average costs of parent company including transaction costs in international trade
AC_i - average costs of independent company
$\overline{0A}$ - sales in the home country of the parent company
$\overline{AB}$ - sales in the foreign country
$\overline{CD}$ - transaction costs in international trade per unit of output

bably could offset the cost-advantage of foreign affiliates over independent competitors. The parent company itself faces a cost disadvantage on foreign markets arising from some sort of the above mentioned transactions costs in international trade, which - for simplicity - are assumed to be porportionate to the units of output sold abroad (AC_p).

In this model, the international division of labour is mainly determined by three different types of costs (Helpman, 1984):

- Comparably high transaction costs in international trade (including artificial trade barriers) are unfavourable to exports and are promoting foreign direct investment and/or entry of independent competitors.
- Comparably high enterprise-specific fixed costs are favourable to foreign direct investments.
- Comparably high costs of monitoring production abroad are favourable to exports and/or entry of independent competitors.

With the cost structure given in figure 1 parent company's exports of the quantity AB would be more profitable than raising a foreign affiliate or market entry of independent competitors.

In this context, government regulations could be interpreted as shifts of average cost-curves. The introduction of trade regulations would be equivalent to an upward shift of AC'_p, thus promoting foreign direct investment and attracting domestic firms. Operating restrictions on multinational corporations, on the other hand, would bring about additional costs to foreign affiliates and would result in an upward shift of AC_a. Such regulations would create exports of the parent company and/or entry of new firms. Restrictions on entry, finally, would raise the cost-curves AC_a and AC_i and would probably result in increasing exports of the parent company. Hence, a survey of existing regulations in service markets should pay attention to the types of international transactions that are affected.

2. Regulations in particular industries

All over the world services are the subject of abundant and intensive government regulations. In India, for example, no foreign insurance company is allowed to operate; in Spain foreign banks are prohibited from equity participation in domestic companies; in West Germany retail shops are to be bound to close at 6.30 pm and brokers are not allowed to offer contracts with foreign insurance companies; in Pakistan theatres are required to devote 15 percent of playing time to local films; in Sweden advertising is prohibited on radio and television and printed advertising materials are subject to tax; and in Canada banks are prohibited from offering computer services other than those related to banking[1].

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[1] For a survey of regulations in different service industries see GATT (1985), World Bank (1987); Walter (1985), Hindley (1982), OECD (1984, 1986), Subcommittee on Merchant Marine (1984).

Most of these regulations are allegedly enacted to protect consumers. In banking and insurance, regulations centrally aim at avoiding the risks of insolvency and securing the effectiveness of national central bank policies. Since control of foreign suppliers by national authorities is limited, governments prefer strong import restrictions. As a result, domestic banking and insurance companies are sheltered from foreign competition to a large extent. In air transport, too, restrictions are in general motivated by protecting the consumer, especially with respect to high safety quality. These standards are accompanied by import controls in form of restrictive landing rights. In communication services regulations are intended to prevent consumers from unfair pricing of pretended natural monopolies. In most cases governments themselves reserve to the monopoly on installation and operation of telecommunication facilities.

Some regulations explicitly aim at preventing domestic companies from foreign competition. Especially in maritime transport a complex system of cargo reservations is restricting international trade. But also in those industries, where the protection of consumers is the pretended rationale of regulation, the true end of these measures is often to be found in the protection of domestic producers (see, e.g., Findlay, 1984).

Of course, some of these regulations are reasonable means of reducing the risks of market failures. It is widely recognized, for example, that the comprehensive reforms of banking in Chile during the late seventies went much too far (World Bank, 1987). In this industry some sort of government controls like reserve requirements or mandatory asset ratios would improve market performance. The same probably applies to surveillance over insurance companies and to minimum standards on aeronautic safety. In most countries, however, the extent of sophisticated regulation networks obviously exceeds sound safeguards against market failures.

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As a common attribute of government regulations, the allocation of resources will be distorted, the efficiency of production processes is reduced, and output prices of regulated industries are above world-market prices. Protecting some industries is always equivalent to discriminating all others, especially those which depend upon inputs of protected industries[1].

Due to the broad range and complexity of government regulations in services it is infeasible to give a comprehensive overview of all measures at a disaggregated sectoral and regional level. Available information suggests, however, that communication, banking and insurance are generally regulated strongest (table 4). In addition, there are substantial regulations in air transport and maritime transport imposed by national aeronautic authorities and the International Air Transport Association (IATA) and by cargo reservation systems respectively. In other transport (especially freight motor carriers) and in business services, by contrast, the significance of government regulations is limited. In retail trade and personal services, finally, international tradeability still is quite low and restrictions on international transactions would be redundant.

With respect to the type of restricted activities, regulations are concentrated on transborder flows of services. Of course, there are severe restrictions on market entry and operation of business as well. By and large, however, imports of services are more affected by government regulations than foreign direct investment in service industries. In accordance with the model presented above it should be expected, hence, that an intensified international division of labour would show up rather in an increase of foreign direct investment than in increased imports and exports.

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[1] For an estimate of the costs of protection in insurance see Hindley (1982). For an international comparison of efficiency in the banking system see Hanson, de Rezende Rocha (1986).

Table 4 - Main fields of government regulations in different service industries by type of restricted activity

Service industry	Import restrictions	Entry restrictions	Operating restrictions
Maritime transport	x		
Air transport	x		x
Other transport			
Communication		x	x
Financial institutions	x	(x)	x
Insurance	x	(x)	x
Business services			

3. Sectoral patterns of foreign direct investment

As stated above, trade in services amounts to about 20 percent of total world trade. There is no corresponding information available, however, on the ratio of world foreign direct investment in service industries to total foreign direct investment. Only a few countries are reporting such data. For three of these countries a share of 30 to 50 percent of services in total foreign direct investment is to be observed (table 5). And this share is increasing over time for each country.

This increase is most distinct in the sub-group of Asian countries, which includes some developing and newly industrializing countries. Within the service sector banking and finance accounts for less than 50 percent. Foreign direct investment in other service industries is rapidly expanding too, especially in business services. A similar pattern shows up in foreign direct investment of four industrial countries in ASEAN countries (table A1 in the appendix)[1].

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[1] For further analysis of the sectoral structure of foreign different investment in ASEAN countries see Hiemenz, Langhammer et al. (1987), Pangestu (1987).

Table 5 - Foreign direct investment of three industrial countries by region and industry (percent) 1976, 1985

Region/industry	United States		Japan		West Germany	
	1976	1985	1976	1985	1976	1985
World						
Manufacturing(a)	67.5	66.2	59.1	48.3	61.7	54.4
Services	32.5	33.8	40.9	51.7	38.3	45.6
Banking, finance	16.0	15.7	7.8	13.3	6.7	11.1
All sectors	100.0	100.0	100.0	100.0	100.0	100.0
Selected Asian countries(b)						
Manufacturing	74.0	64.6	82.1	72.6	47.7	39.8
Services	26.0	35.4	17.9	27.4	52.3	60.2
Banking, finance	7.9	12.8	3.1	.	.	.
All sectors	100.0	100.0	100.0	100.0	100.0	100.0

(a) Including agriculture, mining, construction, utilities. -
(b) Australia, Japan, New-Zealand, Hongkong, Singapore, Republic of Korea, Taiwan, Indonesia, Malaysia, Philippines, Thailand.

Source: Göbel, Langhammer, Weiss (1988); Deutsche Bundesbank (1987); own calculations.

As transaction costs in international trade in services have actually declined, the discrepancy between trade and investment expansion could not be attributed to intrinsic (natural) trade barriers arising from low tradeability of services. Instead, it appears to be the result of substantial artificial trade barriers raised by government regulations. These barriers (as artificial barriers always do) make it profitable to look for loopholes in the system of protection for domestic firms. For escaping trade restrictions the establishment of foreign affiliates has become a dominant business strategy on attractive foreign markets.

This not only applies to developing countries. In West Germany, for example, foreign direct investment is increasing much more rapidly than trade in services. Within ten years the amount of foreign direct investment in services doubled, whereas foreign investment in manufacturing almost remained constant (table 6). In West German total imports and ex-

ports, however, the share of services amounts to a rather stable level of 25 percent and 15 percent respectively.

Table 6 - Cumulated foreign direct investment in West Germany by industry 1976, 1985

Industry	1976	1985	1976	1985
	Bill. DM		percent	
Manufacturing	42.0	45.0	66.1	51.0
Services	20.3	41.0	32.0	46.4
Banking, finance	3.2	7.2	5.0	8.2
Other industries	1.2	2.3	1.9	2.6
All sectors	63.5	88.3	100.0	100.0

Source: Deutsche Bundesbank (1987); own calculations.

Subsequently, the world-wide increase of foreign direct investment in services should probably not be attributed to a low tradeability, but to a rapidly increasing potential of international transactions in services. It is realised in foreign direct investment and is still latent in international trade. This conclusion suggests, therefore, that liberalization of trade in services could substantially promote overall international trade and could bring about a further intensified international division of labour.

IV. Liberalization and market performance in selected service industries

In recent years deregulation of services has become a lively economic and policy issue. In most countries, however, concrete steps towards an opening of service markets are rather reluctant and incomprehensive. Nevertheless, there are some exceptions that could provide useful insights in the impact of deregulation on market performance. Especially in the United States several major service markets have been libe-

ralized since the late seventies. In addition, the Japanese and the British government are striving for some deregulation of service industries. In continental Europe, on the other hand, the regulatory system in services has remained rather unchanged.

The same applies to most developing countries, and within these countries especially to maritime transport, travel and communication. There were carried out, however, some experiments in deregulating financial markets, which deserve a closer look.

As a matter of fact, there are no clear-cut and commonly accepted lessons about the assessment of deregulation activities in developed and developing countries. Separating the impact of such policies from other determinants of economic activity is, of course, a difficult task. A brief survey of different case studies on this subject could provide, however, some tentative conclusions at least.

1. Deregulation experience of industrial countries

In this context, the analysis of deregulation policies should concentrate on services of a comparably high level of international tradeability[1]. In telecommunications, to start with, administrative restrictions are related to network services and customer devices. On the latter market a worldwide trend of increased competition is to be observed. On network and service markets, on the other hand, there are only a few examples of liberalization.

The most comprehensive approach to deregulation of telecommunications was adopted in the United States. It already

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[1] For a comprehensive discussion of regulations in services and deregulation policies in industrial countries see Soltwedel et al. (1986) and the contributions to Giersch (1987). For a comparison of regulations in Great Britain and West Germany see Peacock (1984). For a survey of regulations in West Germany see Donges, Schatz (1986).

started in 1956, when the market of private branch exchanges (PBXs) was opened to competition. Despite these efforts, however, American Telephone and Telegraph (AT&T) was successful in protecting its monopoly position for customer devices for many years. In order to avoid damages of the network every customer was obliged to use an adapter exclusively sold by AT&T. High prices of these adapters appeared to be a substantial barrier to entry for new competitors. In 1977, this regulation was substituted by technical standards for telephone devices, which were controlled by the Federal Communications Commission (FCC). In consequence, new entrants got access to the market and competition was increased. In addition several steps towards liberalizing value-added services were achieved during the seventies. In 1983, also the network was deregulated by the break-up of AT&T.

All in all, the results of deregulating telecommunication in the United States could be summarized as follows:

- The number of competitors increased. For example, the market share of Western Electric (a former affiliate of AT&T) in customer devices was reduced from 80 percent in 1970 to about 40 percent in 1985. Moreover, many new firms entered the market of telecommunication services, namely of value-added services.

- Product diversity extended. The availability of different services and devices was enhanced due to the market entrance of new competitors and intensified competition among existing firms.

- Prices of long-distance telephone calls declined by 15 to 30 percent. Since cross-subsidizing of different services was not feasible any longer, the prices of local area calls actually rose. On average the prices of telephone calls as a whole decreased by 5 to 6 percent (Soltwedel et al., 1986).

In Japan the monopoly positions of the state-owned company Nippon Telephone and Telegraph (NTT) in domestic telecommunication services and of Kokusai Denshin Denwa (KDD) in international telecommunication activities were ceased in 1985. In addition, several government regulations on customer devices were dismissed at that time. In February 1987, finally, NTT was privatized.

In September 1987 three new firms entered the domestic telecommunication market: Daini-Denden Inc., a conglomerate of 225 firms under the leadership of Kyocera (an electrical machinery company); Japan Teleway, a conglomerate of 290 firms under the leadership of Toyota Motors; and Japan Telecom, a conglomerate of 301 different firms. These new competitors are already providing long-distance calls at a price that is about 20 percent below the price of respective NTT-services.

In transborder telecommunications two new competitors finally succeeded in entering the market of KDD, namely International Telecom Japan (a conglomerate of Mitsubishi, Mitsui, Sumitomo, Matsushita and others) and International Digital Communications Planning Inc. (established by the British company Cable & Wireless, the US-companies Merryll Lynch and Pacific Telesis, and the Japanese companies C. Itoh and Toyota Motor).

Due to this increase of competition further price-cuts of telecommunication services and substantial additional investment in network facilities are to be expected. Cable & Wireless has announced, for example, the installation of an optical fiber connection from the United States via Japan to Hongkong - a project of about 280 Mill. US Dollars that will be finished until the end of 1989.

In Great Britain deregulation of telecommunications took place in the early eighties. It started with the break-up of British Telecom (BT) in 1981 and was finalized by the priva-

tization of BT in 1984. These measures were accompanied by liberalization of service and customer device markets (Carter, 1987). Up to 1984, 72 new sellers of value-added services entered the market and it is estimated that the prices of telephone calls have declined by 15 percent in the meantime.

Another often cited example of deregulated services is the case of air-traffic in the United States. It started in 1978 with the Airline Deregulation Act, which brought about a substantial decrease in market concentration and a decline in prices for domestic flights of about 15 percent from 1977 to 1983. In addition, total employment in air transport rose by 8 percent (Soltwedel et al., 1986). In recent years, some newly founded carriers have disappeared, but prices of air transport services are still lower than under the regime of strongly regulated markets. According to Kahn (1983) event the safety of flights was not affected by deregulation. On the contrary, the number of mortal accidents per mile slightly declined as compared to the early seventies.

A deregulation of trucking was - at least partially - achieved in Switzerland (since 1951), in Australia (since 1954), in Great Britain (since 1968), and in the United States (since 1980). The available information suggests, by and large, that also in these cases output prices were lowered, productive efficiency was increased, product diversity was improved, and monopoly rents have almost disappeared (Laaser, 1986). Apparently, the same applies to the deregulation of bus transport in Great Britain, that was enforced by the Transport Act of 1980 and the Public Passenger Vehicles Act of 1981.

With regard to financial institutions the evidence of deregulation in industrial countries appears to be somewhat equivocal. Luxembourg, for example, has opened its markets for foreign banks and, in consequence, could establish a new and rapidly growing centre of world capital markets. In the

United States deregulation centrally aimed at dismissing several operating restrictions (Streit, 1986). On the other hand, there are also some elements of reregulation to be observed. As a result, the number of financial service offerings increased substantially. The impact of this policy framework on interest rates and the stability of the financial system, however, is less obvious (Evanoff, 1985; Goodhart et al., 1987). Presumably, monitoring a sound deregulation policy in financial markets is far more difficult in banking than in other service industries (Neu, 1986).

The above listed examples are briefly covering the main approaches to deregulation of services in industrial countries. Particular countries not mentioned here are, by and large, still preserving a high level of administrative restrictions, namely in transport, communication, banking and insurance. Above all, in continental Europe governments are still reluctant to liberalization policies. Deregulation of services will remain, therefore, an important policy issue in years to come.

2. Liberalization of services in developing countries: the case of financial markets

As compared to industrial countries, case studies on deregulating services in developing countries are rather limited. Most of them are concerned to financial services, which have been subject to dramatic shifts of market structure and output performance in recent years. In this industry several operating restrictions obviously are necessary in order to facilitate sound macroeconomic monetary policy and to stabilize the financial system of an economy. A comprehensive deletion of administrative restrictions, including reserve requirements and mandatory asset ratios, would probably result in a deletion of the financial market itself[1].

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[1] As mentioned above, Chile gives an example of excessive deregulation policies in banking. For an assessment of this experiment see World Bank (1987).

On the other hand, the development of financial markets seems to be of essential importance in the process of industrialization. In the past, many government regulations have proved to be serious impediments to overall economic growth in some developing countries. Nowadays, it is widely recognized, for example, that administrative restrictions such as interest rate ceilings or foreign exchange controls will not increase domestic investment but reduce savings and stimulate (illegal) capital exports[1]. Governments should concentrate, therefore, on such restrictions that are indispensable instruments of controlling the aggregate supply of money.

In some respect, the enforcement of a credible monetary policy would require particular restrictions on international finance as well. In the absence of such complementary regulations the objectives of monetary control might be undermined by the presence of financial institutions based abroad. In many countries, however, administrative restrictions on international trade and investment in financial services are strongly influenced by (rent-seeking) import competing banks. In an international comparison of 141 countries it was observed that only thirteen did not impose explicit entry restrictions on foreign banks and three others prohibited only the acquisition of majority interest in existing banks (Walter, 1985). In the remaining countries a variety of different restrictions, ranging from market delineation acts to rather arbitrary growth and funding limits, could be observed.

In this context, detailed information on the presence of foreign banks and on entry restrictions for branch offices are provided for a sample of 9 developing countries (ta-

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[1] For the experience of Taiwan, the Republic of Korea and Indonesia with exchange rate ceilings see Fischer (1982).

ble 7). In addition, data on exports of "other private goods, services and income" are shown, that are derived from international balance of payments statistics. This item covers exports of financial services and it should be expected that these exports would reach a comparably high level in countries with low entry barriers to foreign banks. The relative importance of such exports is measured by a comparison to the total amount of merchandise exports.

Table 7 - Entry restrictions facing foreign banking firms and export performance of selected developing countries 1979, 1985

Country	Branch offices of foreign banks		Exports of other private goods, services and income			
	Existing presence	Entry permitted	Mill. SDR		Percentage of merchandise exports	
			1979	1985	1979	1985
Egypt	yes	yes	201	69(a)	10.7	18.3(a)
Israel	yes	yes	564	982	15.3	15.1
Seychelles	yes	yes	2	3(a)	40.0	60.0(a)
Sierra Leone	yes	yes	3	11(a)	2.0	8.5(a)
Malaysia	yes	no	105	513	1.2	3.4
Republic of Korea	yes	no	2068	2417	18.2	9.3
Madagaskar	no	no	5	6(a)	1.6	1.8(a)
Nigeria	no	no	128	29	1.0	.2
Somalia	no	no	7	2	8.5	2.2
Memorandum item: Developing countries	x	x	19278	39436	5.3	7.6

(a) 1984.

Source: Walter (1985); IMF (b); own calculations.

In 1979, the ratio of service exports to merchandise exports was above average in almost all countries that were not restricting entry of foreign banks. In addition, the Republic of Korea could achieve a good performance in service exports. Presumably, entry barriers were redundant at that time or were outmatched by internal liberalization activities (Yew, 1986; Dee, 1986). In 1985, however, the importance of Korean service exports had substantially declined. In most other countries and in the developing world as a whole exports of services were growing more rapidly than merchandise exports. This evidence suggests that liberalization policies related to foreign banks could bring about a substantial increase of service exports.

In recent years, discussion has focussed on offshore banking[1]. By the establishment of such centres, it is argued, a country may yield the benefits from international banking without suffering from disturbances on local financial markets. An offshore-banking centre is mainly characterized by

- business activities carried out only in foreign currencies and with non-residents,

- the absence of artificial regulations such as exchange controls, asset ratios or taxes on earnings and transactions.

Consequently, competition is fierce and spreads between deposit and lending rates are low. The stability of these markets is not guaranteed by any official "lender of last resort", but by business connections to parent companies and, in a sense, by some moral commitments of the Bank for International Settlements and the IMF (Walter, 1985). Essential preconditions for the successful establishment of such cen-

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[1] For a summary of this discussion see Valentine (1985) and Choi (1986).

tres seem to be political stability of the host country and the availability of adequate communication facilities.

Direct benefits for the host country are limited, because even minimal levels of taxation can quickly price a centre out of the market. There are, however, substantial indirect benefits arising from a transfer of banking know-how and a stimulus to domestic financial markets. Moreover, offshore banks are often attracting complementary services like international monetary brokers, factoring and leasing companies or insurance and reinsurance institutions. Hence, the development of other industries and of the whole economy might be enhanced. Due to these advantages the number of countries that decide to enter this market is still growing.

Two of the most impressive examples of raising an offshore-banking centre are provided by Singapore and Bahrain. In Singapore, offshore banking has started in 1968. Nowadays, this country has become one of the most important financial centres of that region next to Hong Kong[1]. Expansion was even more rapid in Bahrain, where offshore banking started in 1975. It has become the main centre for the recycling of Petro-Dollars and is especially engaged in financial services submitted to Saudi-Arabian clients (Seznec, 1987).

As many offshore banks are not obliged to disclose their business activities to national authorities, statistical information on profitability and actual international transactions is limited. In Bahrain, for example, only those banks engaged in domestic and offshore markets as well are required to report their activities to the Bahraini government. It should be expected, that officially documented ser-

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[1] For a detailed survey of financial markets and institutions in Singapore see Huat (1985).

Table 8 - Exports of other private goods, services and income by selected offshore-banking countries 1985

Country(a)	Total	Percentage of merchandise exports
	Mill. SDR	
Bahamas (1965)	99	33.9
Bahrain (1975)	931	34.0
Barbados (1963)	89(b)	26.9(b)
Panama (1970)	142	7.4
Singapore (1968)	1910	9.0
Vanuatu (1971)	10	55.6
Memorandum item: Developing countries	39436	7.6

(a) In brackets: Year of establishment of offshore banking. Other offshore-banking countries, that are not reporting service exports: Bermuda (1969), Cayman Islands (1979), Hong Kong, Lebanon, Liberia, Netherlands Antilles (1963), St. Christopher and Nevis (1983). In Hong Kong, Lebanon and Liberia restrictions of offshore banking never existed. - (b) 1984.

Source: IMF (1986); own calculations.

vice exports do not include, in general, offshore banking services. A favourable export performance of offshore-banking countries in the category of "other private goods, services and income" could be attributed, therefore, primarily to exports of complementary services attracted.

As a matter of fact, offshore-banking countries appear to be highly competitive service exporters (table 8). The indirect benefits from liberalized offshore markets appear to be very substantial. Of course, some offshore activities are carried out at the expense of government revenues elsewhere. To some extent, these centres could also be regarded as important conduits in laundering of "dirty" money (Beard, 1986). In consequence, some pressure for extended supervision of offshore activities is to be expected for the future. In general, however, offshore markets have proved to be efficient institutions of international capital transactions.

V. Conclusions

The main purpose of this paper was to demonstrate, both theoretically and empirically, how government regulations of service industries are affecting international transactions. By and large, international trade in services is more restricted than foreign direct investment. This regulatory pattern could explain, why the expansion of international trade in services appeared to be very disappointing as compared to the rich opportunities arising from the advent of new technologies in disembodied services. To some degree these impediments to an intensified international division of labour have been offset by rapidly increasing foreign direct investment in service industries. Such substitution strategies were probably reducing the welfare-losses resulting from trade barriers, but they cannot completely compensate them.

The potential benefits from deregulation policies are discussed for industrial countries and developing countries as well. Several case studies for industrial countries have impressively revealed that in deregulated industries industrial concentration is lower, productive efficiency is higher, product diversity is greater and output prices are lower than in strongly restricted industries. In developing countries some deregulation experiments in services have been carried out in financial markets. The evidence clearly suggests the existence of substantial positive externalities of liberalizing financial services. Deregulation of onshore and offshore financial markets apparently attracts complementary services, promotes service exports and could help in improving current accounts.

Moreover, it should be considered that domestic firms could be made more efficient by their exposure to international competition. Such improvements could be achieved, of course, not only in banking and finance, but also in other service industries. The strong commitments of governments to regula-

tions in services appear to be, in general, beneficial only to particular protected producers, but inflictive to overall economic development.

With this in mind, progressive GATT-negotiations on trade in services would unlikely result in a zero-sum game. Instead, substantial gains from trade might accrue to each participant.

Table A1 - Foreign direct investment of four industrial countries in ASEAN countries(a) by industry

Industry	United States		Japan		West-Germany		Netherlands(b)	
	1976	1984	1976/77	1982/83	1976	1984	1976	1983
Manufacturing (c)								
Mill $	4947	8712	3431	9492	102	223	625	1966
percent	93	88	87	89	56	37	91	91
Services								
Mill $	399	1234	515	1165	79	375	67	187
percent	7	12	13	11	44	63	9	9
Banking and finance								
Mill $	182	651	98	129	33	227	19	141
percent	3	7	2	1	18	38	3	7
All sectors								
Mill $	5346	9946	3946	10657	181	598	690	2153
percent	100	100	100	100	100	100	100	100

(a) Indonesia, Malaysia, Philippines, Singapore, Thailand. - (b) Asian LDC's. - (c) Including mining, construction and utilities.

Source: Langhammer, Gross (1986).

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