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Can a Growing Services Sector Renew Asia's Economic Growth?

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SUMMARY To continue Asia's economic growth the focus for expansion and improvement must move from export manufacturing to the services sector—primarily to cross-border trade in such modern services as finance, information and communication, and professional business services. As the Asian services-sector economies have historically been dominated by personal services rather than by more information-intensive services, serious concerns exist about their ability to rapidly and successfully grow these modern services. While Asia does have some well-known services-sector success stories—such as in India and the Philippines—most Asian services economies have a history of relatively slow developmental change. Removing internal and external policy and structural constraints will be key to productivity growth in modern cross-border services trade. Improving educational opportunities and strengthening infrastructure and capital and labor markets will all be needed complements to regulatory reform if Asia is to grow new and innovative service providers.

Asia's Path to Economic Growth

Asia's sustained rapid growth has been fueled, to a large extent, by export-oriented industrialization. High savings and investment rates, in some cases augmented by large inflows of foreign investment, have facilitated a rapid buildup of the physical-capital stock. Openness to foreign technology has further expanded the capacity of these economies to make and export goods. The manufacturing sectors of the region are woven together into a regional production network in which different economies specialize in different parts of the production process, further boosting productive efficiency and the region's role as a global manufacturing hub. Reallocation of labor from low-productivity agriculture to high-productivity manufacturing has supported the region's sustained rapid growth. For the last half-century, this labor-intensive, export-oriented, manufacturing-based growth paradigm has delivered the best of both worlds—economic growth with jobs—for Asia.

In many Asian economies the manufacturing sector is now maturing, however, and its productivity has reached high levels. As economies approach the current technological frontier, easy opportunities for catch-up dissipate and increases in labor productivity slow.[1] As this process unfolds the manufacturing sector's capacity to generate employment attenuates. The waning ability of the manufacturing sector to generate jobs underscores the necessity of vitalizing services industries, which tend to be even more labor-intensive, to maintain the growth of employment.

Growth in the services sector contributes to inclusive growth and political stability

International considerations. Strengthening the services sector also has a diplomatic rationale. While Asia's economies have, for decades, grown faster than those of the rest of the world, the continuing reverberations from the global financial and economic crisis of 2008–2009 have clouded the region's prospects. Although the crisis centered on advanced Western economies, and not Asia, these Western economies still absorb a large share of Asia's manufactured exports and Asia has been adversely affected by the West's slow recovery.[2] The post-crisis growth slowdown in the advanced economies means that domestic Asian demand—and hence services which cater largely to domestic demand—must contribute more to Asia's future growth.

Services-sector development is thus a component of rebalancing growth away from an excessive reliance on exports. Advanced economies have, from a global perspective, a comparative advantage in modern services such as business services. Liberalizing imports of such services can be beneficial not only to Asian economies but will also contribute to reducing imbalances in global trade. When the manufactured-export engine is stalling, igniting the services engine can help offset the loss of growth.[3]

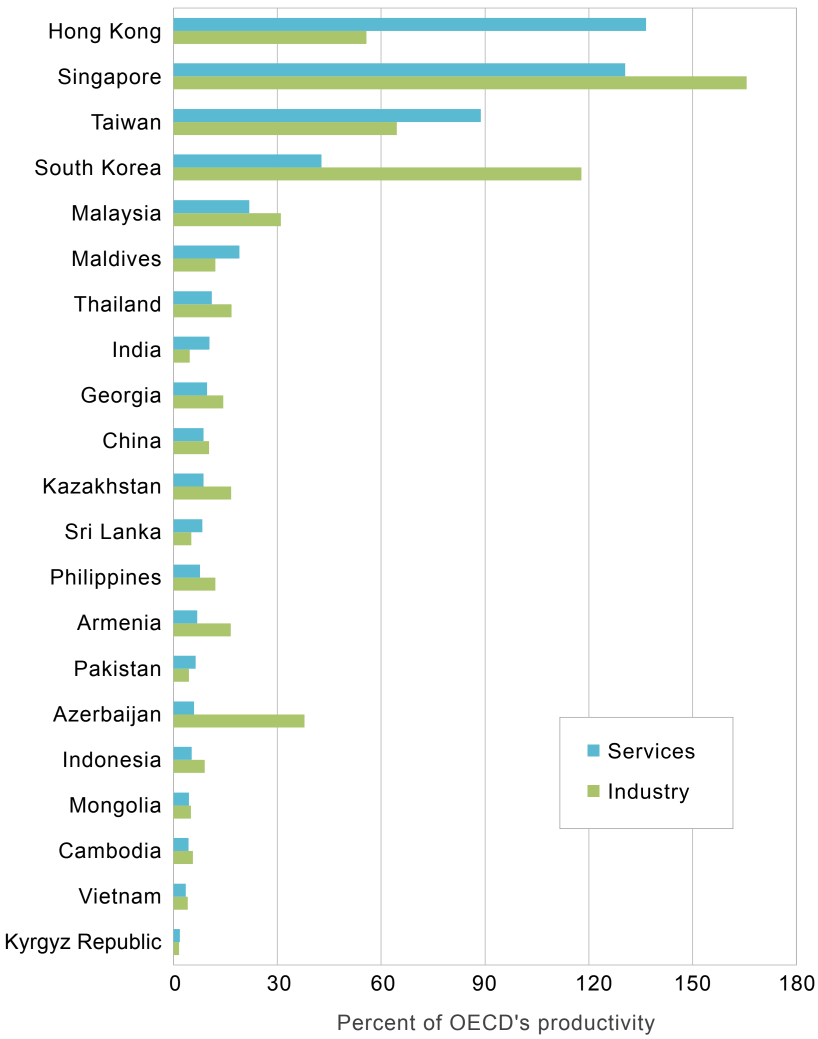
Domestic incentives. The imperative to strengthen the services sector is reinforced by domestic political considerations. Many Asian economies are experiencing rapid growth of their elderly populations—and older citizens typically consume fewer manufactured goods and more services than younger populations. To the extent that many of these services are either provided by or financially underwritten by the public sector, improvements in services-sector efficiency will have a positive impact on government budgets.

A dynamic services sector can contribute to Asia's quest for more-inclusive growth, bringing broader swathes of the population into the economic-growth process and spreading more widely the fruits of such growth. Relative to manufacturing, services tend to be more labor intensive and there is statistical evidence that growth of the services sector is associated with poverty reduction.[4] Growth in the services sector therefore makes a contribution to inclusive growth and political stability.

Is Asia up to the task? The case for raising productivity in the services sector is overwhelming. Achieving such gains, however, will be difficult. While export-oriented industrialization transformed Asia into the world's factory, the region's record in the services sector has been less impressive.

Asia does have some well-known success stories—such as India's emergence as the world's leading exporter of information and communications technology-business process outsourcing (ICT-BPO). The Philippines is also a major ICT-BPO hub. Even in these economies, however, success appears to be rather narrow, concentrated in a few internationally tradable service industries such as software programming and customer help services, rather than the services sector as a whole.

Figure 1. Labor productivity relative to OECD, late 2000s



Sources: Asian Development Outlook 2007: Growth Amid Change, Manila: Asian Development Bank; Authors' calculations based on data from International Labour Organization (2011), *Key Indicators of the Labour Market,* 7th Edition; and World Bank, World Development Indicators online database (accessed April 16, 2012).

In much of Asia the services sector badly lags both international best-practice standards as well as the efficiency of the local manufacturing sector (figure 1). In some cases, even where there are strong services sectors, these sectors appear to be enclaves little connected to the rest of the economy. Can Asia successfully address this need for a stronger services sector?

Asian Services in a Global Perspective

Compared to agriculture, mining, and, most of all, manufacturing, in Asia the services sector has long been minimalized in both the public imagination and economic research. One reason is the sheer diversity of the sector, encompassing such an enormous range of activities as to discourage any easy encapsulation. The economists Barry Eichengreen and Poonan Gupta argue that the broad aggregation of services obscures two distinct "waves" of services-sector growth.[5] They see the first wave occurring in "traditional" services (such as personal services) early in the development process with relatively low levels of income. The second wave is seen to occur later in the development process, with higher incomes, in more information-intensive services (such as business, communications, computer, and technical services) possessing greater scope for cross-border trade.

Business services. It may be useful, for examination, to focus on a subset of services activities such as business services. Here the prospects for high-wage employment and cross-border trade appear strong—with less political sensitivity than in such sectors as education or health.

Services output globally, including in Asia, shows a positive correlation with per-capita income and educational attainment. Eichengreen and Gupta argue that services-sector output rises at a decelerating rate until it levels out when incomes average around $1,800 per capita. Then it accelerates again when incomes average around $4,000 per capita before eventually leveling off (all in 2000 purchasing-power-adjusted US dollars). See figure 2.

Education aids in successfully adapting foreign innovations to the local economy. The second wave appears to be stronger in democracies, in economies near major financial sectors, and in economies relatively open to trade. It also appears that the per-capita-income threshold for the second wave has declined since about 1990—presumably reflecting the increasing diffusion and use of information technology.

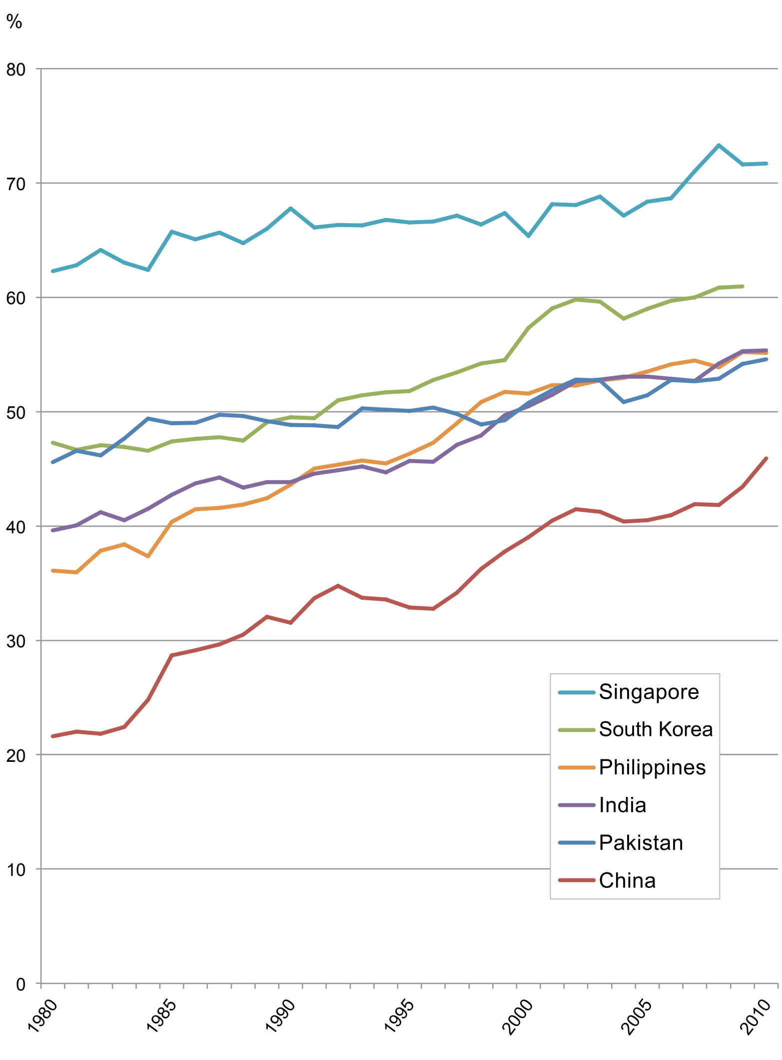
These tendencies suggest a process in which cross-border trade and investment are important diffusion mechanisms—with democracies being more open to information technology, possibly placing a greater emphasis on education, and offering lower risk to foreign investment. This suggests that Asia's developmental challenges are concentrated among a group

Services trade within Asia has been constrained by inconsistent multilateral, regional, and bilateral agreements

of economies where educational underperformance imposes the greatest social costs.

Cross-border trade. Services trade has risen steadily as a share of world income for the past quarter century. While services clearly play an increasingly prominent role within many economies, in Asia the expansion of cross-border services trade is less evident. This may partly be caused by such policy impediments to cross-border exchange as domestic regulations blocking or impeding foreign service providers from accessing domestic markets. Services trade within Asia has not been supported effectively by multilateral, regional, and bilateral agreements.

Figure 2. Services as percent of GDP in selected Asian economies



Source: World Bank, World Development Indicators online database.

The General Agreement on Trade in Services (GATS) identifies four international modalities: trade in services where physical interaction between the buyer and seller is unnecessary, analogous to trade in goods; consumption abroad where the consumer travels to the provider (e.g., tourism); commercial presence where the provider establishes a facility in the client's country (e.g., investment); and temporary movement of service providers to the client (e.g., migration). These different modalities create differing issues. Negotiation to address these issues is complicated since economies have differing comparative advantages and interests in liberalization across the range of differing service activities.

Services-trade-policy restrictions tend to decline with increasing per-capita income.[6] Causality appears to run in both directions: More-open economies tend to grow faster and become wealthier—and wealthier economies with large services sectors tend not to impose restrictions on important and politically influential industries that significantly contribute to their wealth.

Asian competitiveness. Differences seen in the performance of Asian services imports and exports suggests that the competitiveness of Asian service providers may be an issue. Aggregate figures may not adequately illuminate critical issues having a significant impact on trade outcomes. The degree of connectedness of the services sector to or the diffusion of services-sector productivity within an economy, however, may not be immediately visible.

An economy may have a large information-technology sector but that sector may be an enclave essentially oriented toward the global market. It may consume little from the domestic economy and its output may not be significantly consumed within the domestic economy. As a consequence its links to the rest of the domestic economy are weak and advances in this sector do not generate much productivity enhancement for the rest of the economy.

Another example might be a tourism sector based on cultural, historical, or natural endowments. This also may function as an isolated enclave with little spillover to the rest of the domestic economy.

In contrast, in South Korea the public-policy emphasis on broadband access has encouraged the wide adoption of information technology and helped contribute to propagating services-sector innovations throughout the national economy.

Low Productivity of Asia's Services Sector

While the services sector has been rapidly growing across Asian economies, services growth is still led by traditional activities. As in the past, such traditional services as hotels and restaurants, personal services, public administration, real estate, transport, and wholesale and retail trade continue to dominate (table 1).

Far from dominating are such modern services as finance, information and communication, and professional business services. These activities comprise only about 8 to 12 percent of the economies in China, India, Indonesia, Taiwan, and Thailand. In contrast, in the advanced economies of the Organization for Economic Cooperation and Development (OECD), such as France, Japan, and the United States, modern services account for about 17 to 25 percent of their economies. Only Hong Kong, Singapore, and South Korea maintain modern services at levels comparable with those of the OECD. Modern services are internationally marketable and offer opportunity for economies to widen, as well as to diversify, their foreign trade. Advanced economies have shifted toward a larger modern-services sector that has higher productivity and generates higher wages than traditional services.

For most Asian economies labor productivity is less than 10 percent that of the OECD

The services gap. A huge gap separates Asia's productivity in services from that of the OECD. For most Asian economies labor productivity is less than 10 percent that of the OECD. Some of these economies have caught up with the OECD—notably Hong Kong, as early as 1990, and Singapore, in 2000. Taiwan trails only slightly behind.

Most Asian economies show rough estimates of average growth in productivity at 4 percent for 2000–2009, indicating it might take another 15 to 30 years to reach one-fifth of the OECD's current services productivity. Using China's and India's historically higher roughly 8 percent growth rates for services productivity, it will take only about 10 years for these two economies to reach one-fifth OECD levels.

In other Asian economies services-sector efficiency has barely improved over the past decade. In some economies with relatively large services sectors—such as Pakistan, the Philippines, and Sri Lanka—labor-productivity improvements have been only around 2 to 3 percent per year.

While South Korea's productivity level has achieved 40 percent that of the OECD, over this period its labor-productivity growth has been less than 1 percent. According to some estimates, South Korea's total factor productivity growth—which takes into account both capital and labor inputs—has actually been negative.[7,8] In Thailand labor productivity in the services sector has been stagnant.

Industrial productivity. As in services, there is a significant gap between the industrial-productivity levels of Asian developing economies and those of the OECD. Still, in most Asian economies, the gap between local efficiency levels and OECD standards is less dramatic in the industrial sector than in the services sector.

In some South Asian economies—particularly India, Maldives, Pakistan, and Sri Lanka—the reverse is true: Their services sectors are actually closer to OECD productivity levels than are their industrial sectors. But these are exceptions; overall, most Asian economies face a daunting task of closing the services-sector productivity gap.

Great opportunity. In a positive light, this shows there is great opportunity for productivity growth in services and thus for services to contribute to Asia's future economic growth.

While a major shift toward a larger services sector has occurred in most economies in the region, the composition of this services sector has remained largely unchanged. Gauging by the past evolution of service activities, achieving a more sophisticated modern services sector is likely to be a slow process. Asian economies can either wait for their historically slow process or initiate bold steps to speed changes.

While moving toward modern high-productivity services is desirable for economies trapped in traditional low-productivity services, traditional labor-intensive services such as tourism will have a continuing role in generating employment and reducing poverty.

Table 1. Share of services in value-added, the increase in the value of output less material input costs, 1990 and 2010 (%)

Economy	Total Services		Trade		Hotels and Restaurants		Transport and Storage		Real Estate and Dwellings		Communication, Finance, and Business Services		Public Administration, Community, Personal, and Other Services	
	1990	2010	1990	2010	1990	2010	1990	2010	1990	2010	1990	2010	1990	2010
Developing Asia														
China	31.5	43.4	6.8	8.5	1.6	2.1	3.8	4.9	2.1	7.3	9.4	9.4	7.9	11.2
Hong Kong	87.2	92.9	21.8	24	3	3.3	7.7	8.1	5.1	5.2	19.4	24.4	30.3	27.9
India	46.1	54.7	11.8	15.1	1	1.4	6.4	6.3	5	6.1	8.7	11	13.3	14.5
Indonesia	42.4	37.7	13.5	10.9	3.2	2.8	6.1	3.4	2.9	2.6	6.5	7.8	10.1	10.2
South Korea	51.5	58.5	11.8	8.3	2.4	2.4	4.7	4.5	6.5	8.1	11.2	16.4	14.8	19.2
Malaysia	44.9	46	10.9	11.9	2.2	2.3	3.8	3.3	5.4	4.1	14.4	14.6	8.3	9.7
Philippines	50.8	55.1	14.7	17.4	-	-	3.2	3.9	5.8	6.5	11.5	13.9	15.7	13.4
Singapore	67.8	71.7	13.1	16.5	3.5	2.2	11.4	8.6	3.6	4.1	26.6	29.6	9.6	10.7
Taiwan	55	66.2	13.4	18.8	1.7	2	4.6	3.3	6.4	8.9	11.4	12.4	17.5	20.8
Thailand	50.9	43	17.8	13.1	5.4	4.7	4.5	4.1	2.2	1.4	11.3	7.7	9.7	12
OECD														
United States	73.4	80.2	12.9	11.6	3.4	3.8	3	2.8	12.1	12.2	18.9	25.1	23	24.8
Japan	59.8	72.6	12.8	12.3	-	-	4.9	4.5	9.4	13	13.6	17.2	19.1	25.7
France	69.2	79.7	11.8	10.6	2.3	2.6	4.6	5	9.8	13.4	18.9	22	21.7	26.1

"-" means data not available.
Notes: Initial data for Hong Kong and Malaysia refer to 2000; Indonesia 1993; and Philippines 1998. Latest data for China and Japan refer to 2009.
Sources: Authors' estimates based on data from CEIC Data Company (accessed April 25, 2012).

Productivity advances in the services sector benefit manufacturing and the economy as a whole

Fostering services-productivity growth requires tackling both internal and external constraints created by public policy. Liberalizing trade and foreign direct investment (FDI) in services can, as it has for goods trade, promote efficiency and productivity. One opportunity is in the import of modern business services from advanced economies. To ensure productivity growth in the services sector as a whole, rather than just creating a few high-productivity enclaves, it is, however, vital to remove such domestic constraints as excessive regulation. The more-competitive marketplace resulting from removing internal and external constraints is key to productivity growth.

Positive spillover. Slow productivity growth in the services sector retards economy-wide productivity growth. Conversely, productivity advances in the services sector generate benefits for manufacturing and the economy as a whole.

Efficient information and communications technology (ICT) and transportation promote productivity across the entire economy. Use of specialized modern service activities can contribute to cost reduction and faster product innovation in the industrial and even agricultural sectors, generating rising incomes throughout the economy.

The growing international tradability of services driving the emergence of global supply chains in sectors such as health care, presents growth opportunities for a region already heavily involved in global manufacturing. Governments can help advance modern-services sectors through policy reform and investing in physical infrastructure and human capital.

Comparing India's growing less-regulated ICT-BPO sector with China's more-limited services sector (arguably caused by China's pro-manufacturing policies) demonstrates how removing policy constraints benefits economic progress. The Indian and Chinese experiences show how policy constraints affect services-sector growth.

Governments can create more conducive environments for the modern-services sector by improving physical infrastructure, such as telecom connectivity, and by addressing education/human capital needs. A strong infrastructure and an adequate supply of educated human capital are especially needed for such modern services as information and communications technology-business process outsourcing.

Policy Recommendations

Asian economies must support their services sectors to improve employment opportunities and both internal stability and international relations. Traditional services still dominate in the lower-income Asian economies while modern services are increasingly significant in the higher-income economies. This diversity forces each Asian economy to address individual priorities in services-sector development—but strengthening modern services remains a region-wide imperative.

Strong modern services can stop Asian economies from becoming trapped at the middle-income level

The intangible nature of many services takes nothing away from their very real economic effects in employment and broader economic dynamism. Efficient energy, distribution, and transportation networks boost productivity in manufacturing. Strong modern services—especially business services such as design, marketing, and prototyping—can stop Asian economies from becoming trapped at the middle-income level and lead them into higher-value-added activities generating higher incomes.

The services sector already accounts for a large share of Asia's employment and output. Industrialization—during which employment and output in industry and services typically rises at the expense of agriculture—is strong throughout most of Asia, even in the less-developed economies. Services-sector growth already makes a sizable contribution to the region's economic growth.

Services-sector development can continue to reduce poverty in a region which, despite great progress, still remains home to almost two-thirds of the world's poor. In part because traditional services still account for a large share of Asia's services sector, most Asian economies lag far behind OECD economies in terms of efficiency. There remains great opportunity for further growth and development.

Unleashing potential. The productivity gap between Asian economies and OECD economies strongly suggests the removal of policy and structural constraints to free the Asian services sector to better serve as an engine of employment and growth. Recognizing the regional diversity, one answer will obviously not fit all in identifying needed reforms. Specific changes must be tailored to local circumstances. Still, certain themes appear broadly applicable.

Foremost among these would be the encouragement of competition in the provision of services. This may require the removal of burdensome regulations traditionally protecting existing firms but stifling competition and innovation.[9] International experience demonstrates that regulatory reforms often deliver significant economic benefits including increased labor productivity with lower prices.[10] Where services are now provided by public entities, competition can be encouraged through regulatory reforms fostering choice and innovation without necessarily privatizing existing institutions. Opening education to convenient entry by private providers is just one example.

Regulatory reform may be necessary for such changes—but it is unlikely to be sufficient. Strengthening capital and labor markets will be a needed complement to regulatory reform to establish and grow new and innovative service providers.

Competition can also be imported. Government constraints on services trade and on allowing foreign service providers impedes domestic competition in services. Reducing barriers promotes efficiency and provductivity and contributes to growth and exports. India's well-recognized success as ICT-BPO exporter is a prime example.

Overall the guiding principle for Asian policymakers must be to create a more competitive environment for their services industries.

Notes

[1] Robert Barro, "Convergence and Modernization Revisited," National Bureau of Economic Research Working Paper 18295 (Cambridge, MA: NBER, 2012).

[2] International Monetary Fund (IMF), *Gradual Upturn in Global Growth During 2013* (2013), http://www.imf.org/external/pubs/ft/weo/2013/update/01/.

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