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International Trade in Services: Implications for the IMF

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International Trade in Services: Implications for the IMF

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Abstract

This paper reviews the characteristics of international trade in services and of the World Trade Organization's General Agreement on Trade in Services (GATS) framework, which was established to regulate it. Further liberalization of services trade in developing countries, as currently envisaged in the context of the WTO Doha Development Agenda, holds a number of potential benefits, such as underpinning the liberalization of goods trade, but it is also being resisted due to its potential adjustment costs. Two implications for IMF activities are examined: coherence among the three principal international economic institutions and sequencing with macroeconomic stabilization and regulatory reforms.

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I. INTRODUCTION

In recent years, IMF surveillance and conditionality in the context of IMF-supported programs have increasingly covered services sectors of member countries. This trend in part reflected the growing importance of services in the economies of IMF member countries and the growing momentum in the liberalization of services trade. The IMF's work has been concentrated in the financial sector, but also extended to the energy, retailing, telecommunications, and transportation sectors. In this work, the IMF has generally viewed a competitive services sector as essential for sustained economic development and stability, as significant policy and market distortions in services can derail the achievement of these policy objectives. Trade policy is a crucial component of the regulatory framework pertaining to services, and has important macroeconomic, financial, and balance of payments implications in its own right.

This paper reviews the IMF's experience with trade policy reform in services sectors, examines the existing multilateral framework for the liberalization of trade in services, and distills lessons for the future work of the IMF. The focus is on the broad issues arising for the IMF from the growth in international trade in services and from the emergence of a body of international law pertaining to services trade within the WTO. These issues relate to: (1) the need for coherence with other international institutions, in particular with commitments countries have entered into in the context of the WTO's services agreement and with the work done by the World Bank; (2) the potential macroeconomic implications of trade in services; and (3) complexities in the design of trade policy reforms in services sectors, particularly as regards complementarities with the liberalization of goods trade, privatization, deregulation, and capital account liberalization.

The role of services has changed dramatically in recent decades**.** Services represent the largest single sector in developed economies and increasingly in developing economies as well, accounting for nearly two-thirds of value-added and employment in the former and about half in the latter. Services are also the fastest-growing component of international trade. Since 1980, services exports have grown more strongly than merchandise exports and now amount to about US$1.5 trillion annually, or about one-fifth of total world exports.

Progress in communications technology has facilitated the provision of services based on telecommunications networks and the outsourcing of producer services, including to foreign providers. The recent growth of services in developed countries, for example, has been fuelled in part by "new economy services" such as e-commerce, software production, and other services.

Efficiency in the production of services has an important bearing on economic performance and development**.** Services like transportation and distribution, education and health, and banking and finance are of critical importance in developing countries, both for the emergence of a competitive manufacturing sector and, more broadly, for social development and poverty reduction. In many poor countries, economic and social development is hampered by the lack of adequate basic infrastructure such as roads, power supply, telecommunications, and public transport (World Bank, 2002). Openness to services trade may therefore entail major benefits by helping the poorest countries to obtain infrastructure services at internationally competitive prices. The liberalization of transportation and financial services, for example, is expected to significantly lower costs in merchandise trade. Where countries have opened up to international services transactions, they have enhanced the efficiency of existing domestic services industries by attracting fresh capital and providing incentives for restructuring inefficient companies.

Trade in services has important implications for the balance of payments. Many developing countries have benefited from exports of construction, banking, and professional services or from services transactions based on telecommunications networks (such as data processing and entry, and software production). Remittances from nationals residing abroad and the compensation of residents temporarily employed abroad represent important currency revenues, in some countries rivaling export receipts. Furthermore, international services trade has important implications for capital flows. Recent estimates suggest that nearly 60 percent of international services transactions are conducted through foreign affiliates of multinational companies. Already, nearly one-half of the total outward FDI stock of OECD economies is in services sectors.

This paper is structured as follows. Section II examines the characteristics of services trade: how restrictions can be measured, key elements of the WTO's General Agreement on Trade in Services (GATS), and a number of risks and benefits from liberalization identified in the empirical literature. Based on a review of the IMF's work in three surveillance cases and of five program countries Section III then reviews the motivations for and the key elements of the IMF's work relating to services sectors. Finally, Section IV sets out considerations for future work, relating to coherence with the work of other institutions, sequencing, and regulatory issues. Section V concludes.

II. Tradable Services

The service sector comprises a variety of highly heterogeneous economic activities. Services can be classified into distributive services (wholesale and retail, transportation and communications), producer services (advisory, legal services, banking and finance), social services (health and education), and personal services (hotels and catering). However, as a legal concept for international trade rules, the sector has only been defined since the beginning of the GATT's Uruguay Round.

Services tend to be intangible, nonstorable, and typically require simultaneous production and consumption. Services are often intermediate inputs, and thus play a key role in the efficiency of the manufacturing sector and the economy as a whole. Public regulation is more pervasive than in other sectors, and motivated by asymmetric information between providers and consumers, competition policy, and other policy objectives, such as universal service requirements in a number of social services.

A. Types of Trade

The close link between trade in services and factor mobility is due to the fact that the provision of services typically requires direct interaction between the service provider and the service consumer. Only in some cases can services be transmitted without such a physical presence, as for instance in cross-border finance or where a service is embodied in goods or in information provided through communication networks. In this context, the emergence of services trade on the internet has been a major structural change in the nature of international services trade (Box 1).

Box 1. Internet-Based Services

Rapid progress in the availability of telecommunications links and of computer technology has contributed to a surge of services transactions based on the internet. The internet impacts on three distinct stages in market transactions: first, the buyer's search for product and price information in the market, second, the subsequent order of the product and, third, the delivery of the product. The internet facilitates both the processing of market information and the ordering of goods and services. Moreover, only products that can be converted into digital form can also be supplied through the internet. "Electronic commerce" commonly refers to transactions that actually take place on the internet, that is the second and third stage of a market transaction. Evidence from the United States suggests that online delivery is still a comparatively small segment of this market.

The emergence of the internet as a medium of transaction and delivery has reduced the market entry costs in many service industries, and led to more intense competition. Manufacturing firms will be more inclined to separate vertically-related activities that can be performed by outside service providers. This offers opportunities for service providers in the developing world, in particular in the areas of data and information processing (so-called "back-office" functions). Equally, software design and maintenance no longer need to be provided at the location of the software user. The participation of developing countries in the strongly growing market for internet based services is, however, dependent on their access to a modern telecommunications infrastructure.

Estimates of the size of world electronic commerce range from US$218 to US$657 billion, though the majority of this market is currently located in the United States. The diffusion to developing countries is expected to be rapid. The number of internet users in India, for instance, was estimated at over 2 million at the end of the year 2000. Outside the United States, electronic commerce is highly likely to be export-oriented, with an increasing share of business-to-business transactions (Mann, 2000). The growth of this market offers significant potential for small developing countries, though it also raises the risk of marginalization for countries with poor telecommunication networks.

Trade in services is defined to cover four modes of supply:

- *Cross-border supply (mode 1):* the service consumer is in his country of residence, while the service supplier is outside the country of the consumer; examples are transportation services or internet-based trade.

- *Consumption abroad (mode 2):* the service consumer moves outside his home territory and consumes services in another country; examples are tourism or education overseas.

- *Commercial presence (mode 3):* the service supplier establishes, through foreign direct investment, an enterprise in the territory of the consumer and supplies the service to the consumer; examples are services rendered by foreign-owned banks.

- *Temporary movement of natural persons (mode 4):* an individual who is either self-employed or working on behalf of his employer moves to the territory of the consumer to provide the service; examples include services provided by an on-site engineer.

Recent cooperation between a number of number of international organizations has defined the statistical coverage that would proxy these four modes of supply (United Nations and others, 2002). However, there are still serious shortcomings in recording the item "other services" (other than travel and transportation) in the balance of payments. Deficiencies are even greater in recording sales through commercial presence. Few investor countries record the sales data of firms owned by residents but operating outside their territory and equally, only few host countries to FDI distinguish the sales of foreign-owned affiliates in their corporate statistics.

B. Impediments to International Services Trade

Given the characteristics of services, the traditional instruments of trade policy, such as tariffs or quantitative restrictions imposed at the border generally do not apply. Instead, trade in services tends to be restricted mainly through direct controls on market access and through treatment of foreign providers that is less favorable than that of national ones. Even when not explicitly targeting foreign providers, domestic regulations can reduce international services trade. In the classification of Stern (2000) four kinds of barriers are normally distinguished:

- quantitative restrictions or prohibitions on the provision of services by foreign residents;
- price-based measures may be applied through differential taxes on the transactions of foreign providers, or through additional charges on the regulatory processes that they engage in;
- additional licensing or certification requirements, in particular on providers of business or professional services;

- lack of access to distribution (retail) and communication networks; this kind of barriers often stems from the absence or the inadequate enforcement of national competition standards.

C. Openness to Trade in Services

A quantification of barriers to international services trade is important both to gauge potential efficiency gains, and to complement existing measures of the restrictions imposed on goods trade. Several studies suggest that gains from trade liberalization will remain elusive where key services sectors remain closed to foreign entry.

Regulatory measures are harder to quantify than barriers in goods trade. A quantification of market access barriers and of discrimination against foreign suppliers suffers not just from the inevitable judgment in assigning weights to individual regulatory measures but also from the paucity of comparable data. The GATS only discloses restrictions where members chose to include a particular sector in their schedules of specific commitments, thereby locking in their policy regime (Mattoo and others, 2001). Outcome-based measures, such as price-cost margins or market shares of foreign service providers, measure economic distortions more accurately, but cannot always unambiguously attribute such distortions to economic regulations.

A number of measures indicate that developing and transition economies tend to have more restrictive trade regimes in services sectors than developed countries.[2] The greater openness of developed countries is nevertheless a recent phenomenon and is linked to the wave of domestic deregulation that took place over the past two decades, particularly, in financial and telecommunications services. In developing countries, commercial presence still appears to be the most restricted mode of market access. Restrictions apply to the type of legal entity under which the supplier can establish local presence, and to the extent of foreign capital participation. Restrictions on national treatment, on the other hand, affect aspects like

[2] See the restrictiveness indices for a large number of sectors and countries that is available at http://www.pc.gov.au/research/memoranda/servicesrestriction.

administrative authorization, and land ownership. Restrictions on commercial establishment in national service sectors also account for the bulk of investment restrictions overall.

While many countries have been liberalizing their services sectors unilaterally or in the context of regional agreements, the role of the WTO as a multilateral forum for liberalization has increased markedly in recent years. The Uruguay Round led to the creation of the GATS, which covers all services sectors and provides a comprehensive set of multilateral rules covering international trade in services as well as a forum for continuous negotiations (Box 2). During the Uruguay Round, and in subsequent agreements, participating countries made specific commitments to provide access to their national services markets. The most notable concessions lay in financial services, telecommunications, health and some social services sectors. While most countries essentially bound their regime in place at the time, such “bindings” have enhanced the predictability and transparency of market access regimes. Moreover, the GATS will provide a framework to circumscribe anticompetitive practices by foreign service providers, and the conduct of state-owned service providers.

Substantial multilateral liberalization of services trade can be achieved in the context of the Doha Development Agenda. In early 2003, WTO members presented a first round of offers on a bilateral basis. Apart from a number of rule-making issues, the key challenge in the ongoing trade round will be to find a compromise between industrial country demands for further liberalization of market access in developing countries—in particular with regard to the commercial presence mode—and the demands of developing countries for concessions on the temporary movement of natural persons (mode 4). Very few unconditional commitments have so far been scheduled for mode 4, and the discussion at the political level often confuses mode 4 with migration, that is a *permanent* movement of persons. From the perspective of industrialized countries, this issue basically relates to independent consultants, and to skilled personnel moving within multinational firms and seeking employment in industrialized countries. However, for many developing countries the stakes are much higher. In several Central American countries, for example, remittances amount to more than five percent of GDP, and in some cases rival exports as the primary credit in the current account. Recent studies argue that substantial welfare gains and poverty reduction can be expected if the rights of temporary movement were to be extended to less skilled workers from developing countries (Winters, 2002).

Box 2. The General Agreement on Trade in Services

The most important **general obligation** in the GATS is the most-favored-nation (MFN) treatment. It binds the GATS members to treat services providers in the same way as they would treat those from their most favored trade partner and prohibits members from discriminating between services and services providers from different member countries. The MFN obligation is weakened by the fact that members may exempt trade measures relating to services sectors from MFN treatment. Such exemptions, however, have a limited duration and could only be taken during the Uruguay Round and in the follow-up sectoral negotiations. Other general obligations relate to requirements such as transparency and disclosure of information, economic integration, recognition of standards, domestic regulation and monopolies, emergency safeguards and other general issues. The GATS requires countries to allow capital inflows related to foreign establishment and free movement of capital related to cross-border financial transactions, when they are an essential part of the provision of a service. However, safeguards and rules on capital mobility allow countries to impose restrictions on the provision of services and related transfers (including capital controls) if their balance of payments is under threat, in consultation with the IMF.

Besides accepting general obligations, members make **specific commitments** to liberalize market access and national treatment in selected sectors. Within each sector, members make commitments for different modes of services supply. An example of a liberalization commitment might be allowing a 60 percent foreign equity participation in domestic banks. Even when listed, liberalization commitments are subject to qualifications, which can significantly weaken the liberalization and its binding.

The articles described above define the GATS' **hybrid approach** to multilateral liberalization of international services markets. On the one hand, there is a general MFN obligation, which is limited by a “negative list” of exceptions. On the other hand, there are sector-specific market access and national treatment commitments, which are made by means of a “positive list approach”. These are again subject to a “negative” list of nonconforming measures (i.e., the measures that violate principles of market access and national treatment). The extent of liberalization under this hybrid approach, therefore, is reflected in the number of services sectors not listed in the exceptions to the MFN obligation and in the sectors entered under the positive list of commitments for which no nonconforming measures are maintained.

The GATS also includes seven annexes, which outline issues in **specific services sectors**, among them professional services, air transport, financial services, maritime transport, and telecommunications. The annex on financial services, for example, recognizes the need for adequate prudential regulation, but contains provisions that restrict such regulation from being used as a barrier to foreign providers. Prudential measures are not considered restrictions, and measures undertaken for monetary policy purposes are outside the scope of the GATS.

Even though the GATS provides the most comprehensive framework to deal with the liberalization in services trade, there is a risk that it is being undermined through the proliferating bilateral and regional trade agreements, most of which now also include provisions on services. Given that the GATS Art. V on regional agreements is as yet illdefined—let alone enforced—discriminatory treatment may distort services trade, and reduce efficiency gains.

D. Gains and Risks Stemming from the Liberalization of Services Trade

Liberalizing international trade in services is likely to yield substantial gains in welfare and growth. By reducing the margin between the prices of foreign and domestic services, a country will increase national welfare, in a way comparable to the liberalization of goods trade. Because many services are intermediate inputs in the production of goods and other services, this can be compared to a reduction of a tax on downstream sectors.[3] For example, exporters in many developing countries face higher costs due to the extensive protection awarded to national carriers and cargo service providers, as reflected in higher cif-fob margins (Box 3). However, unlike in the case of goods trade, few barriers to services trade are price-based, and hence liberalization rarely entails a loss in fiscal revenue. Adverse terms of trade effects are also unlikely for small countries. Additional benefits could derive from factor movements that result from market access commitments for commercial establishments (mode 3) or the temporary movement of natural persons (mode 4, see Winters, 2002).

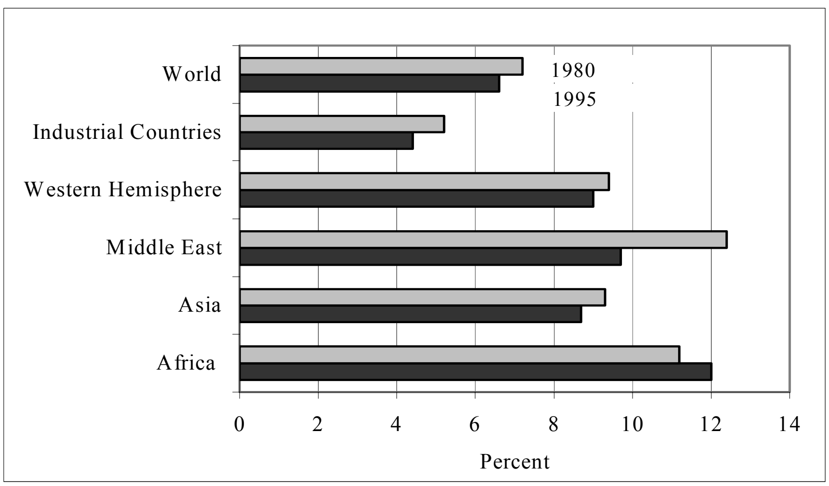
Recent empirical studies indeed substantiate these potential gains, in particular in developing countries. One study suggests that open financial and telecom sectors may increase growth rates by up to 1.5 percent (Mattoo and others, 2001). Global welfare effects from a services liberalization have been estimated to be on a par with those from a complete elimination of trade barriers in manufactures and agricultural goods. Such gains are intuitive, given the pervasive role of services in both developed and developing countries, and the comparatively high barriers to international trade. For developing countries, welfare gains were estimated to

[3] These effects are sizable. In the case of Egyptian manufacturing, services account for about 36 percent of inputs, and barriers to services trade are estimated to be equivalent to a tariff of 15 percent. See Hoekman and Braga (1997).

Box 3. The Impact of Service Trade Restrictions on FOB/CIF Margins

Distribution services play a key role in determining the price at which imports are sold within any given market, inclusive of the cost of insurance and freight (CIF). Low cost imports of industrial equipment and production inputs are critical in the development process. However, there is ample evidence that small low income countries pay much higher unit prices for their imports than larger and more open countries. As Figure 1 below demonstrates, import costs at premia over world prices are at least in part attributable to inadequate distribution services. The margin of CIF prices over original shipment prices ("free on board," or FOB) has declined in every region, except Africa, where this margin is highest. Recent studies document the extensive protection that African governments have granted their national carriers and cargo service providers, thereby increasing costs for both importers and exporters, and reducing incentives for investment in export-oriented sectors.[1/] Liberalization of transport services—both for the international shipment of goods (cargo services and handling in domestic ports) and for local transportation—could help to overcome barriers some countries face in accessing markets in industrial countries.

Figure 1. CIF Margins over FOB Prices by Region, 1980 and 1995



Source: *International Finance Statistics*

1/ Amjadi and Yeats (1995).

be two to three times larger in proportion to national incomes than in industrialized countries. A general equilibrium model of Tunisia suggests that the liberalization of a number of key services sectors could yield gains equivalent to seven percent of GDP.[4]

[4] For a summary of these empirical studies see OECD (2002).

At the same time developing countries have voiced concerns over the risks from further services liberalization. One key concern is the implications of commitments on services trade for capital account liberalization (see section IV.A). Another concern relates to the impact on poverty. Opening domestic service sectors to foreign competition, for instance through privatization, may of course raise—rather than lower—prices. Liberalization of individual services sectors may hence have a substantial adverse impact on household expenditures, in particular in areas such as utilities or infrastructure. The local establishment of foreign services providers—just as the market entry of new domestic competitors—may, of course, also displace unskilled labor, or put at risk the universal provision of utility services. Mitigating these risks requires careful sequencing and pacing of services liberalization, particularly in relation to broader regulatory, fiscal, and social reforms (see section IV.B).

In the multilateral context, concerns over the exposure of individual services sectors to foreign competition can be addressed within the existing legal framework of the GATS. The GATS contains a number of provisions that could provide relief from any adjustment needs following liberalization. Balance of payments imbalances, for instance, provide grounds for adopting restrictions on trade in those service sectors in which the member has undertaken specific commitments (Article XII). There are also proposals to introduce a safeguard clause that would provide relief from the *effects* of liberalization (comparable to the safeguard on goods imports in GATT Article XIX). However, this would risk undermining the transparency and predictability of market access regimes, and is resisted by most parties to the current negotiations. Provisions in the Financial Services Agreement also preserve the powers of regulatory bodies to intervene in support of financial stability (see the literature cited in footnote 2). While to date, developing countries have limited the scope and depth of their commitments under the GATS, and are likely to seek further policy flexibility in the ongoing negotiations, some developing countries have unilaterally entered concessions outside ongoing negotiations, seeking to enhance predictability and transparency of their market access regimes (Adlung in Sauvé and Stern, 2000).

III. Services Trade in IMF Surveillance and Conditionality

The growing importance of trade in services has been reflected in the increasing attention that the IMF has given to policies in a number of service sectors. The IMF's involvement has been predominantly concerned with financial services, and, to a lesser extent, with telecommunications, transportation, and distribution, areas in which the IMF has cooperated with the World Bank. However, trade in services—the presence and nondiscriminatory treatment of foreign service providers—was not addressed systematically and only touched upon as a by-product of broader concerns. Such concerns related to the strengthening and development of the financial system, the enhancement of the role of the private sector through privatization and deregulation, and the promotion of competition in specific sectors. As a consequence, service sector issues are taken up in a number of analytical contexts in IMF documents.[5] In a number of countries, IMF missions have emphasized the synergies between services trade liberalization and other structural reforms, especially domestic deregulation, privatization of utilities, financial reforms and trade liberalization in goods sectors. Based on a review of country reports for recent IMF surveillance and use of IMF resources, a number of the benefits of more open services markets appear to have motivated the IMF's involvement (see Boxes 4 and 5 for selected results on these activities):

- Trade reforms in services have typically been undertaken in the context of the modernization of the domestic regulatory framework to foster **competition among or privatization of services companies**. In many cases, the aim was to achieve efficiency gains by attracting foreign technology and expertise to improve the operational efficiency of former state-owned companies. For example, in South Africa the IMF emphasized the potential efficiency gains from privatization of an

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[5] Headings include "equity markets and foreign direct investment," "foreign exchange liberalization," and "strengthening the legal and supervisory framework for banking." The relaxation of ownership limits on local banks in Indonesia was announced in the MEFP of January 1998 on the grounds of strengthening the legal and supervisory framework for banking, while it is implemented under the liberalization of the capital account in the Korean program of December 1997.

airline and an airport service company through foreign investment. More broadly, in recent Asian programs, the opening of the financial sector to foreign participation was intended to reduce structural weaknesses and to attract foreign capital and expertise in order to revive ailing financial institutions.

- The IMF was directly involved in the liberalization of trade in financial services in the context of regulatory and structural reforms aimed at promoting the development of a **sound financial sector** (for example, in Ukraine and Azerbaijan).

Box 4. Trade in Services in IMF Surveillance

In **Brazil**, IMF staff regarded reform in the key services sectors—telecommunications, transportation, and finance—as a priority. Subsequent policy was closely linked to privatization. The structural reform agenda covered privatization of state-owned bank Banco Real, the national telephone company Telebras, and the leasing of ports, airports, and highways. The policy analysis focused on the efficiency gains from services liberalization and privatization, government revenues from privatization and concessions, and the related implications for the reduction of state debt. Employment effects were discussed, and the implications for balance of payments of developments in services trade, especially tourism, were examined.

In **South Africa** issues concerning trade in services were raised in relation to the impact on the balance of payments, foreign direct investment and privatization. Services, particularly tourism, and the privatization of the telephone state monopoly Telecom through its sale to a foreign consortium were highlighted as important factors that influenced the balance of payments. Implications of the privatization of an airline company Sunair and the airports company also were examined. The privatization of the national airline was linked to the rationalization of the financial structure of Transnet, the transportation conglomerate.

A recent surveillance mission to **the EU** discussed progress toward the creation of a single market in services and in international services negotiations, highlighted the positive interactions between internal reform and international commitments, and emphasized the gains for both the EU economy and the world economy of more open and competitive services markets. In Article IV consultations with each European country, as part of structural issues, trade in services is discussed. While being consolidated in the EU schedule of commitments, GATS commitments are country-specific. Therefore, individual EU member states have significant leeway in determining the degree of liberalization in a particular service sector. As both EU single market reforms and multilateral commitments have a considerable impact on market structures, the domestic and international aspect of service trade liberalization are important for overall economic performance.

Box 5. Trade in Services in IMF-Supported Programs

In **Ukraine,** attracting foreign direct investment was viewed as an important objective of the Extended Fund Facility. With a view toward supporting private sector development, the program promoted deregulation and privatization of medium and large enterprises and, in particular, accelerated cash sale of large and attractive enterprises in telecommunications, air transportation, and the energy sector through transparent tender procedures and stock markets offers. An important component of the financial sector reform was the opening to foreign participation through simplifying licensing procedures and lifting the limit on total foreign capital participation in the equity ownership of the Ukranian banking system. The liberalization of entry for foreign services providers proceeded in parallel with the upgrading of the regulatory framework in the respective sectors.

Azerbaijan's 1996 Extended Fund Facility had as the main objective of its structural polices enhancing productivity growth, thereby enabling the non-oil tradable goods sector to survive. The focus was on bank restructuring, privatization, and termination of government's involvement in production and trade. This effort also required the adoption of the needed legal framework (Bankruptcy Law, Competition Law, etc.). The program included measures to improve conditions for foreign investment in the energy sector (e.g., Petroleum Law); seeking both foreign and domestic strategic investors in the tender privatization of large enterprises (10 percent of enterprises to be privatized); intention to accept obligations of Article VIII, Sections 2, 3, and 4; and the development of private banking system by creating a level playing field for private banks relative to state-owned banks. This latter entailed free entry and exit for domestic and foreign banks. The program contained a structural benchmark, which was implemented, inviting foreign banks to raise their capital up to 30 percent to total banking system capital. Subsequently, citing the continuing poor health of the financial system, it was noted that this limit on foreign participation in the banking system constrained the transfer of skills and technology (which could strengthen the system) as well as limited the domestic borrowers' access to additional sources of credit. Regarding privatization, it was noted that the effort would contribute to budget financing.

Services liberalization in **Poland** was addressed largely from the perspective of privatization policy and efficiency of the banking sector. After the initial wave of privatization of small retail and service-oriented businesses, attention shifted to larger enterprises, where privatization was more challenging. In the banking sector, the privatization process was initially hampered by some ambivalent attitudes, which at times led to non-market solutions such as the creation of holding companies; substantial progress was achieved in the privatization of state-owned banks through foreign investment.

Recent **Asian programs** provided for extensive opening to foreign participation in banking (Indonesia, Korea, Thailand), other financial services (Korea), telecommunications (Korea, Thailand), and distribution services (Indonesia). Wide-ranging liberalization of services sectors was in those cases intended to enhance efficiency and resilience in key services sectors and to attract foreign capital and expertise. For example, the opening of distribution services to foreign investment in Indonesia aimed at increasing competition and efficiency in the domestic economy by allowing for freer and more transparent distribution channels. The lowering of foreign ownership thresholds in Indonesia, Korea and Thailand allowed foreign banks to take effective control of ailing domestic institutions and thus to facilitate their restructuring. In addition, the lifting of branching restrictions (Indonesia) aimed at creating a level playing field throughout the country, as foreign institutions had initially been confined to selected urban centers.

In **Kenya** the participation of foreign strategic partners in the privatization of public utilities was recommended by the IMF and the Bank primarily owing to potential efficiency gains and the need to address governance issues. In particular, the liberalization of services trade was largely motivated by the privatization of public enterprises in telecommunications (Telecom) and the banking sector (Kenya Commercial Bank). The authorities were taking steps to sell 49 percent of capital in the Telecom company and the Kenya Commercial Bank to foreign strategic partners.

- The **privatization of public utilities**—often combined with opening up to greater foreign participation—is an example of structural reforms that follow initial stabilization efforts with the aim of promoting private sector development and reducing quasi-fiscal deficits. In this context, the World Bank has normally taken the lead on the specifics of services liberalization, while the IMF has supported reforms by setting appropriate inflation and fiscal balance targets.

- The IMF has also encouraged the liberalization of services trade to support export promotion strategies, which typically require the provision of high-quality services at competitive prices, with a view toward strengthening **export competitiveness** and, ultimately, the **balance of payments**. In some African countries, for example, IMF staff has emphasized that lack of infrastructure for timely delivery had constrained the potential for agricultural exports.

- Addressing **governance and transparency** problems was also an important motivation for IMF involvement in services sectors. In Kenya, privatization in the telecommunications and banking sectors was intended to reduce incentives for corruption and rent-seeking, and improve efficiency. Similarly, in Indonesia the liberalization of distribution services was recommended primarily in order to enhance governance and transparency.

IV. Further Liberalization: Issues for the IMF

Through its surveillance and program conditionality the IMF's work has frequently touched on aspects of regulatory reform in services sectors. Currently, WTO members embark on a second round of services negotiations which comes at a time of heightened public sensitivity toward foreign entry into national services industries. In this section we examine two issues that will be critical for any future IMF involvement: coherence with the obligations entered into under the WTO and advice given by the World Bank; and proper sequencing with macroeconomic stabilization and capital account liberalization.

A. Coherence

The IMF's policy advice in services sectors is directed at underpinning macroeconomic and financial stability through improvements in efficiency, transparency, and regulation. The WTO, on the other hand, is the forum within which member countries enter into multilateral obligations regarding their services sectors. General obligations such as nondiscriminatory treatment and sector-specific commitments allow countries to open their services sectors gradually, while credibly locking in market access conditions in individual sectors.

The IMF's advice therefore needs to be consistent with the general obligations under the GATS (see Box 2). Nevertheless, IMF advice or conditionality may call for deeper, broader, or faster market access concessions compared with what countries would undertake through their schedules of commitments. Two difficulties remain. First, WTO members are concerned that autonomous liberalization such as that taken in the context of IMF-supported programs is not given sufficient negotiating credit in the ongoing negotiations. A framework for crediting such unilateral liberalization was agreed at the WTO in March 2003, but remains to be tested in practice. In the meantime, negotiating partners are likely to remain very sensitive to IMF advice or conditionality in this area for fear of weakening their negotiating position. Second, unilateral reforms negotiated with the IMF are not "bound" in the GATS schedules and thus could be reversed later. Hence, until such measures translate into binding market access commitments they will lack the transparency and predictability that are often critical for service providers, in particular for those with a local establishment.

The potential implications of services trade liberalization for capital account opening also raise important challenges for the collaboration between the IMF and the WTO.

- In the context of its surveillance, financial sector assessments, technical assistance, and financial support macroeconomic adjustment, the IMF provides advice to members on their financial sector policies. Through this work, the IMF could help avoid potential tension between the sequencing of financial liberalization in the national and multilateral contexts. In principle, the GATS is designed to avoid such conflicts. It is intended to complement national reforms by promoting MFN treatment, transparency and stability of the services trade regime. It also allows countries to maintain restrictions for reasons other than limiting market access and national treatment, such as prudential and monetary and exchange rate management. In practice, however, these so-called "carve-outs" leave considerable discretion.

- The GATS requires members to liberalize capital inflows related to the establishment of commercial presence and capital flows essential for cross-border trade in financial services in line with their specific commitments. However, it allows the use of capital account restrictions in case of balance of payments difficulties, for prudential reasons, and at the IMF's request. According to Art. XI of the GATS, the WTO defers to the IMF on matters in the IMF's jurisdiction, in particular regarding restrictions on payments and transfers for current international transactions and capital controls imposed at the request of the IMF (Box 6). As set out in GATS Article XII, it is bound to base its conclusions regarding restrictions made for balance of payments reasons on the factual input and assessments of the balance of payments situation provided by the IMF.

As regards the collaboration between the IMF and the World Bank, procedures that ensure coherence have been in place longer. The IMF approaches trade liberalization in services from the perspective of the overall macroeconomic performance, financial stability, and external viability, while the World Bank focuses on the design of sector-specific policies. As in goods trade, the IMF would normally provide general advice on the pace and sequencing of services trade liberalization and identify the prerequisites for such liberalization. This would include an assessment of the macroeconomic—particularly fiscal—balance balance of payments implications of liberalization. The regulation of services sectors is of course highly sector-specific, and based on the guidelines for Bank-IMF collaboration, and according to the IMF's 2002 surveillance review, the World Bank would typically take the lead on

Box 6: Trade in Financial Services and Capital Movements[1/]

Trade in financial services gives rise to capital movements under two modes of supply: (i) when a service provider makes a direct investment to establish *commercial presence* abroad, and (ii) when a service provided *across borders* induces a capital movement. To what extent a service provided under mode 1 entails a capital flow is highly specific to the nature of the service. Cross-border trade in some services (for example, consulting, advisory, and information services) does not require a movement of capital, while other services (for example, lending) inherently involve capital movements. Many financial services represent an intermediate case, whereby their trading across borders is accompanied by capital movements.

In this case, the respective transactions in the services and capital accounts can be distinguished based on the following principle: Services transactions concern *access* of domestic consumers to *services* provided by foreign-owned suppliers or exports of services by domestically-owned providers and give rise to payments of *service fees, charges, and commissions*. Capital account transactions reflect *access to financial markets*—residents' use of foreign capital or nonresidents' use of domestic capital—resulting in payments of *interest, dividends,* and *profits*. For example, a service transaction whereby a resident purchases services of a foreign asset management company is distinct from the related purchases or sales of foreign securities (if any) which are to be recorded in the capital account. Understanding the complex links between trade in financial services and capital movements is crucial for designing financial liberalization programs, both in the national and multilateral contexts.

The extent to which the national liberalization of trade in a financial service requires liberalizing the capital account depends on the type of service and the way it is supplied. Supplying financial services through commercial presence requires liberalizing inward direct investment in the financial sector but does not generally preclude the application of other capital controls, e.g., on the repatriation of capital. When foreign-owned affiliates are incorporated (typically in the form of subsidiaries) in the host country, they are considered residents of this country.[2/] Although services transactions of such affiliates may involve capital movements, resident foreign affiliates could be subject to capital controls and thus would be able to engage only in those services transactions that involve capital movements permitted under the host country's capital account regulations. If capital controls do not discriminate between foreign- and domestically-owned residents, they would not violate the national treatment condition in GATS.[3/] In contrast, the liberalization of cross-border trade in financial services would require liberalizing the accompanying capital movements, except for those services that are independent of capital movements.

In the multilateral context, the liberalization of financial services trade constrains countries' ability to use capital controls. GATS members have agreed not to restrict capital account transactions inconsistently with their specific commitments in services liberalization (GATS, Article XI), even though under the IMF's Articles of Agreement (Article VI, Section 3) members may exercise capital account restrictions. If a member makes specific commitments to liberalize financial services trade, GATS requires the member to also liberalize capital inflows "related" to the establishment of a commercial presence and capital inflows and outflows "essential" for cross-border trade (GATS, Article XVI, footnote 8).[4/] However, capital account restrictions proscribed under GATS (and even restrictions on current payments and transfers) can still be imposed in case of balance-of-payments difficulties (GATS, Article XII), for prudential reasons (Annex on Financial Services, Section 2), and at the IMF's request (GATS, Article XI). The latter carve-out refers to the IMF's right to ask a member using IMF resources to impose capital account restrictions under certain circumstances (Article VI, Section 1 of the IMF's Articles of Agreement, though this is a provision that has never been invoked).

GATS defers to IMF jurisdiction concerning restrictions on payments and transfers for current international transactions and capital controls imposed at the request of the IMF (GATS, Article XI). In determining the validity of restrictions made for balance of payments reasons, the WTO must base its conclusions on the IMF's balance-of-payments analyses (GATS, Article XII). While the balance-of-payments carve-out clearly specifies modalities for imposing restrictions, the prudential one leaves ample room for discretion. In particular, it does not specify which measures could be considered prudential or what the basis for such a determination is. A possible role for the IMF in evaluating the need for prudential measures is currently under consideration.

1/ The box draws on Tamirisa and others (2000).

2/ Branches are often treated as nonresidents, and services trade transactions through them would thus be analogous to cross-border trade.

ever, when assessing discrimination, if such controls put foreign-owned providers at a de facto competitive disadvantage, the fact that they are nondiscriminatory may be insufficient to meet the standard.

4/ It is possible in principle that for modes other than commercial presence and cross-border trade, members schedule to liberalize trade in a financial service but not the related capital account restrictions. However, given that commercial presence, and to a lesser extent cross border trade, are the primary modes of financial services trade, this possibility appears remote.

microeconomic issues.[6] For example, the Bank provides assistance to countries in designing specific restructuring and privatization programs and in drafting new laws for the regulation of telecommunications and transportation sectors. In the area of financial sector reform it shares this responsibility with the IMF. Structural measures in these areas are often included as part of conditionality under Bank lending operations.

B. Sequencing and Complementarity with Other Reforms

Service sector liberalization—and IMF advice—need to proceed cautiously where supporting macroeconomic conditions or regulatory reform are not in place. As in goods trade, the costs in terms of capital reallocation and labor displacement will be larger should there be a shortfall in aggregate demand, or imbalances in the budgetary sector. External balance and exchange rate stability are also key considerations for foreign service providers, in particular those seeking a commercial presence in the market. Clearly, liberalization of trade in services will require the lifting of any exchange controls on current payments for scheduled services transactions, and income repatriations (though the obligations under the IMF's Article VIII are now widely accepted).

Eliminating market entry barriers and treating foreign service providers on a nondiscriminatory basis relative to domestic providers (national treatment) and relative to each other (MFN treatment) are only a subset of the objectives of regulatory reforms in services sectors. Domestic regulators also pursue the objectives underlying their competition policies, seek to ensure basic health and safety standards, and social objectives, such as the universal provision of certain services. Upgrading the domestic competition, bankruptcy, and standard-setting regulations and institutions often needs to precede the opening to foreign service providers, in particular in network industries such as telecoms. Otherwise, domestic incumbents could continue to engage in anticompetitive behavior and dilute the efficiency gains from liberalization. Other considerations for regulatory reform are:

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[6] See "Biennial Review of the IMF's Surveillance and of the 1977 Surveillance Decision–

(continued…)

- Commercial presence is the key mode of services provision in most sectors. Liberalizing the regulations affecting foreign direct investors promises early and lasting efficiency gains in terms of transfers of skills and technology. The typically superior management and employment practices are also likely to underpin political support for continued liberalization.

- Trade in services needs to be liberalized with a view toward complementing privatization and the liberalization of goods trade. Following the liberalization of goods trade, continued restrictions on services trade—in particular in the transport sector –may unnecessarily undermine the competitive position of import-competing industries, and impede the growth of export-oriented firms.

- Social expenditures to lower the temporary burden of adjustment are likely to strengthen the political support for and the sustainability of services trade liberalization. The magnitude of adjustment costs—and thus the need for any support measures—depends on the speed of market opening, and on the experience with competition in the domestic market. Support measures could include active labor market policies, such as the retraining of employees.

Clearly, there are no simple blueprints for opening domestic service sectors to foreign competition. In the financial sector, for instance, there is a much studied tension between the efficiency gains from increased competition and skill transfers on the one hand, and short term risks to financial stability on the other. Recommendations for safeguarding prudential standards in periods of financial liberalization will be highly country-specific.[7] Similar sector-specific concerns for regulatory reform arise in important sectors such as transportation, distribution, or telecommunications.

Overview ” available at http://www.imf.org/external/np/pdr/surv/2002/031302.pdf

[7] See, for example, Levine (1996), Dobson and Jacquet (1998), Kono and others (1998), Barajas and others (1999), Tamirisa and others (2000), IMF (2000), and Kireyev (2002).

V. Conclusion

The regulation of international trade in services covers a widely heterogeneous set of economic activities, types of trade, and usually sector-specific domestic laws and regulations that discourage or impede foreign competition. This paper has discussed the growth in services trade, and reviewed some of the potential benefits and risks from liberalizing it further. Many countries have liberalized international services trade unilaterally, or in bilateral, regional, and multilateral trade agreements. Through its surveillance, program, and technical assistance activities, the IMF has often been involved in this process. The IMF's focus has been primarily in financial services, though we have also documented the involvement in a number of other sectors.

Since 1994, the GATS has established a multilateral regulatory framework for international services trade, and in the ongoing WTO round this agreement will be refined further. While the GATS provides opportunities for countries to credibly lock in their policy regimes and reap the benefits of more open services markets in the multilateral context, it also raises issues of coherence between the policies promoted by international institutions, including the IMF, the WTO, and the World Bank. The key tenets of the GATS—transparency of regulatory regimes, and nondiscriminatory treatment of foreign service suppliers—provide powerful incentives that will help to attract the capital, expertise, and access to international information networks that global service companies control. Yet, opening to foreign service competition needs to be sequenced carefully with macroeconomic stabilization, capital account reforms, and the upgrading of domestic regulations, such as corporate governance or financial supervision, giving the IMF an important role, through continued policy advice, in ensuring that all its members benefit from the globalization of services.

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