



Asia-Pacific  
Economic Cooperation

## APEC, Services, and Supply Chains *Taking Stock of Services-Related Activities in APEC*

By Gloria O. Pasadilla and Christopher Findlay

Past meetings of APEC have revealed great interest among APEC economies to focus more attention on services. Services, after all, constitute a large share of APEC economies' GDP and, for most, the top source of employment. Services have also surpassed manufacturing as the largest source of productivity, especially in advanced economies<sup>1</sup>. In this context, questions raised could be summarized into the following: what aspects of services should APEC focus on, which sectors to prioritize, and what role can APEC play? If any APEC-wide policies and programs to support services should be carried out, what should a program which APEC leaders could endorse look like?

Considering emerging trends in manufacturing and the increasingly appreciated importance of services for manufacturing performance and competitiveness, the above questions are highly significant. To assist with discussion on services, this policy brief provides a background of the 'servicification' trend in manufacturing, discusses previous and current APEC programs and projects related to services, and highlights areas for possible APEC discussion.

### Importance of services in APEC

Services is the largest economic sector in most APEC economies, representing 90% of GDP in service-based economies like Hong Kong, China, and 68% of total APEC GDP<sup>2</sup>. Its share in total APEC exports of goods and services appears not to be as significant as the share of goods, estimated at 19% in 2009 and 16.7% in 2012. But when measured more appropriately in value-added terms, the share of services in total exports is actually much higher at 39% - double than what conventional trade measurement shows (see

<sup>1</sup> See Tcha (2011) presentation at the ADBI-PECC Conference on 21st Century Approaches on Services Trade, Hong Kong, China, June.

<sup>2</sup> In constant 2005 US dollar, data is of 2011 and based on most recent available information from the UNCTAD database.

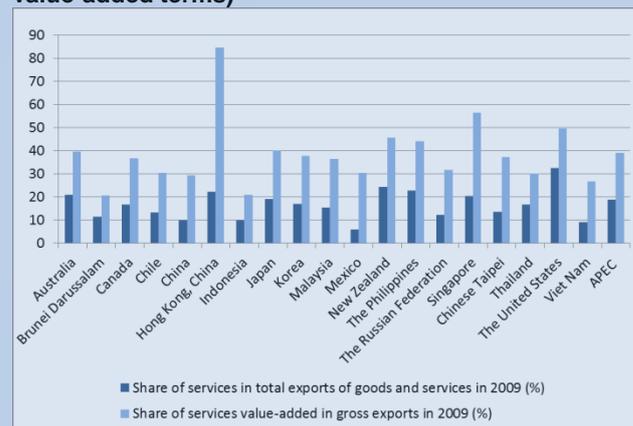
Table 1 and Figure 1). Across APEC, the services sector is much more significant than it appears to be when it is measured in value-added terms because it captures the full extent of its contribution to exports. For example, Figure 1 shows Hong Kong, China's services share to be close to a four-fold increase over conventional measures, from 22% to 85%; China's share is three-times its share using traditional calculations, 10% versus 29%; and Mexico's services share is boosted five-fold, from 6% to 30%.

**Table 1. Services in APEC, at a Glance**

	APEC Economy with highest value	APEC as a whole
Share in GDP <sup>2/</sup>	Hong Kong, China, 90%	68%
Share in total exports of goods and services, 2009	United States, 32%	18.9%
Share in value-added trade, 2009	Hong Kong, China, 84.6%	39.1%

Source: APEC Policy Support Unit computation based on OECD-WTO Trade in Value Added and UNCTAD Stat Database.

**Figure 1. Importance of Services (in gross and in value-added terms)**

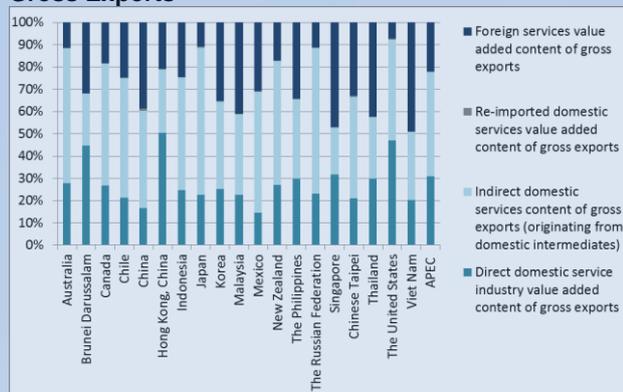


Source: APEC Policy Support Unit computation based on OECD-WTO TiVA and UNCTAD Stat Database <sup>3</sup>.

<sup>3</sup> Note: APEC value in the figure does not include data from Papua New Guinea and Peru.

Figure 2 below shows how services share in gross exports can be subdivided into contributions from: 1) direct domestic service industry; 2) indirect domestic services content; and 3) services that were embodied in imported intermediate goods, which can be either re-imported domestic services or foreign services content. The figure shows that more than 20% of the services component of APEC economies' exports come from imported services (i.e., foreign services value-added in the graph), 30% from direct domestic services input and close to 50% from indirect domestic services inputs that originated from intermediates. It may be surmised that the large share of domestic services content could be partly due to barriers to services trade in some economies, and also probably due to the fact that many services still require proximity between seller and buyer and thus the preference for local service providers. However, some research<sup>4</sup> show that higher shares of 'local services' are actually correlated with more open services policies which brings the question of the importance of foreign direct investments or commercial presence in increasing 'local services content'.

**Figure 2. Services Value-added Component of Gross Exports**



Source: APEC Policy Support Unit computation based on OECD-WTO TiVA database. Data are for 2009 and APEC total does not include Papua New Guinea and Peru.

### 'Servicification' Trend<sup>5</sup>

What the results of the value-added measurements set out above highlight is the ubiquity and importance of services in the manufacturing supply chain. Telecommunication, finance, transport, and distribution – all backbone service sectors – underpin supply chains, but this is only part of the picture. Services are used as

<sup>4</sup> For instance, He and Findlay (2014), unpublished working paper draft.

<sup>5</sup> 'Servicification' was first coined by the Swedish National Board of Trade, see Kommerkollegium (2010).

inputs in every segment of the production process, including the pre-manufacturing and post-manufacturing portions of the supply chain. Examples of pre-manufacturing services are research and consulting, branding, and design; while for post-manufacturing, examples include advertising, marketing, retailing, repairs and maintenance, to name only a few. Within manufacturing itself, business and management services, energy, and communications provide other examples of the ubiquity of services.

'Servicification', the term that has been employed to denote the closer integration of services in manufacturing businesses, developed as advances in communications and transportation have made services more tradable, thus facilitating their incorporation in cross-border supply chain production. In addition, the bundling of services into composite products and the separation of the service activities in manufacturing from the core production function and then contracting out the same services inputs have enabled the 'quantification' of services' contribution. Services inputs that used to be supplied in-house and not at arms-length have for long been either uncounted or misrepresented as part of goods. But with modularization, services have become a separate recognizable and measurable quantity, albeit still imperfectly<sup>6</sup>.

Services have also become increasingly a source of competitiveness for manufacturing, a way to offer product differentiation in highly competitive markets. Services are often packaged as part of a final goods sale, for example, repair and maintenance services as part of its warranty agreement. In some developed economies where environmental regulations require proper waste handling, recycling services have become part of the sale of the electrical appliance. In some cases where the service component is sold separately, even to rival manufacturing product, the offered service has become an important source of income for the enterprise group. In fact, a survey of large manufacturing firms by Deloitte Research in 2006 revealed that 25%-50% of revenues come from services. These services include<sup>7</sup>

<sup>6</sup> Low (2013) discusses the data challenges arising from, among others, the intangibility of services that make them hard to identify and measure and the lack of generally accepted nomenclature for services. The problem is compounded when services are not contracted separately and thus not valued accordingly for their contribution to output.

<sup>7</sup> Barefoot and Koncz-Brunner (2012) reports that for the US, the largest categories of traded services are: use or creation of intellectual property, headquarter and support services, royalties and license fees (especially trademarks and industrial

headquarter services, after-sales services, management services, technical consulting, inventory management, marketing services, brand management, royalties, and others<sup>8</sup>.

For these reasons, services are attracting increasing attention in trade negotiations at bilateral, regional and plurilateral levels. A common assessment is that the proposed WTO Doha Development Agenda (DDA) improvements over Uruguay Round commitments make little headway in reducing the “water” between bound and applied policies on services<sup>9</sup>. The treatment of services in bilateral agreements is generally regarded, so far, as not adding significant reform, and that in fact most progress to date is made via unilateral action. The focus in international cooperation is therefore shifting to the progress in large group arrangements, including the Trans Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP). These follow different approaches to the design of reform commitments. Also important are the plurilateral negotiations on the Trade in Services Agreement (TISA) by a group of WTO members<sup>10</sup>. APEC’s work can provide valuable input to the design and completion of these negotiations, and most likely more importantly to the implementation of any commitments.

The key takeaway from these various studies on the increased intertwining of services and manufacturing is that if APEC economies want to be competitive in exporting goods, their services sector must be efficient and competitive as well. Hence, policies that affect services competitiveness will ultimately affect economies’ capacity to export and to participate in global value chains. An economy’s competitiveness based on labor abundance, for example, may be offset by inefficient transportation and distribution services due to lack of competition. The interest in APEC to take a closer look at the role of services in helping to promote its economic and trade agenda is a much awaited and welcomed intent.

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processes), and business, professional, technical (BPT) services (especially management and consulting, research and development and testing). Moreover, most of services trade was attributable to affiliated transactions.

<sup>8</sup> See DeLoitte (2006) for survey of global manufacturing firms and their increasing use of services in their business strategy.

<sup>9</sup> See ADBI and PECC (2011) for a review of this material.

<sup>10</sup> Issues in the design of TISA are discussed by Hufbauer, Jense and Stephenson (2012) and by Sauve (2013).

## What APEC has done on services

How supportive have past APEC’s projects been of the services-manufacturing intertwining trend? A look at APEC projects with services-related content reveals that, between 2006 and 2012, 38% of APEC-funded projects have been related to services<sup>11</sup> (Table 2). Most of these activities have been workshops and capacity building seminars which represent 24% of APEC projects, while others have been carried out in the form of research studies or survey and database projects. An example of the latter is the APEC Services Trade Access Requirements (STAR) Database which sets out in a transparent manner the regulatory requirements to supply a service in individual APEC economies. The service sectoral working groups like the Energy Working Group (EWG), the Transportation Working Group (TPTWG), and the Telecommunications and Information Working Group (TEL) have the majority of services-related projects according to our count. The Human Resources Development Working Group’s (HRDWG) work on education as well as professional services also has taken a good share of the projects related to services. Some capacity building projects were more ‘general’ in the sense of fostering better understanding of services trade and its importance in the economy or measurement problems related to the sector<sup>12</sup>. Others have been specific to modes of service supply, for instance activities related to foreign direct investment under the auspices of the Investment Experts’ Group (IEG), or on movement of natural persons by the Group on Services (GOS) or the Business Mobility Group (BMG).

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<sup>11</sup> The percentage of services-related projects since the 1990s up to 2012 is less than 10% based on information that the PSU managed to piece together. This suggests that more work on services have been proposed and funded since 2006.

<sup>12</sup> An important and recent example of an APEC activity that seeks to foster better understanding of services was the APEC SOM-ABAC/PECC Dialogue on Services in April 2013, though this was not, strictly speaking, an APEC-funded project. The SOM has since agreed to hold an annual dialogue on the topic. The 2013 meeting drew upon the work on the services sector by ADBI, PECC and the PSU (see ADBI and PECC, 2011). The meeting highlighted the benefits of services reform in terms of direct benefits to consumers and also in lowering business costs. Particularly important in this event was the interaction with the private sector in the design of agendas for reform, since an appreciation of its benefits by the users of services is critical for success.

**Table 2. APEC Services-Related Projects**

Type of Projects	Number of Projects	As (%) of APEC Projects
<b>Workshops/Conference/Capacity Building Seminar</b>	86	24.23%
1. General: services trade	19	5.35%
2. Mode-specific a/	22	6.20%
3. Sector-specific	45	12.68%
<b>Studies/Surveys/Database</b>	49	13.80%
<b>Total</b>	<b>135</b>	<b>38.03%</b>

a/ Mode can be either by 'commercial presence' or investment; movement of natural persons or mobility of persons, either tourism related or people-to-people mobility

Source: APEC Policy Support Unit computation based on APEC Projects Database, 2006-2012.

### **Work dispersion across APEC committees and working groups**

Because the service sector is so large and its regulations handled by various government departments and regulatory agencies, APEC's work on services has been also dispersed across various committees and groups. The Committee on Trade and Investment (CTI) undertakes most of the projects on services along with the subgroups under it, particularly the Group on Services (GOS), the Investment Experts' Group (IEG), the Business Mobility Group (BMG), and the Electronic Commerce Steering Group (ECSG)<sup>13</sup>. These projects have included, among others, the creation of a services regulation database across APEC economies<sup>14</sup> that facilitates the business community's search for information on services regulations in the region; the work on Cross Border Privacy Rules under the ECSG which aims to facilitate cross-border data information exchange; the Investment Facilitation Action Plan (IFAP) under the IEG which seeks to improve and liberalize investment regimes; and the APEC Business Travel Card (ABTC) which facilitates the travel of business people within APEC economies.

The Economic Committee's (EC) continuing work on regulatory reforms has been closely related to services. For example, in 2010, the EC supported

<sup>13</sup> The ECSG was originally one of the task forces under the SOM Steering Committee on Economic and Technical Cooperation (SCE) but was placed under the CTI starting in 2007.

<sup>14</sup> APEC Services Trade Access Requirements (STAR) Database, a project under the GOS, is a comprehensive database of regulatory information. It is useful for businesses looking to access new markets in the APEC region. Currently the database contains information on five service sectors for 11 APEC economies. A project is underway to extend coverage to all 21 economies and to add more service sectors (see APEC website for detailed information).

various studies on reform experiences of selected services sectors like telecommunications, electricity, energy, and several other service sectors. The EC programs also include improving regulatory quality within APEC and it carries this out through capacity building work on regulatory impact assessment (RIA). Projects such as these ultimately lead to facilitation of services trade because, in essence, much of services liberalization is about regulatory reforms.

Under the SOM Steering Committee on Economic and Technical Cooperation (SCE), various sectoral groups meet regularly and carry out projects that are related to services. For example, the Human Resources Development Working Group (HRDWG) has undertaken several projects on cross-border higher education which touch upon trade in education services. Likewise, the Telecommunications and Information Working Group (TEL), the Transportation Working Group (TPTWG), the Energy Working Group (EWG), and the Tourism Working Group (TWG), each carries out various programs and initiatives in each of their respective service sectors. These sectoral groups do not take a 'big picture' approach but stick with specific sectoral concerns in discussing regulatory issues that facilitate, for example, interoperability in telecommunications systems or multimodal transport.

The APEC Policy Support Unit (PSU) has also undertaken some work on services. For example, the 2011 project on Structural Reforms in the Transport, Energy and Telecommunications Sectors found that introducing a package of reforms based on a series of pro-competition measures would increase productivity in these sectors by between 2% and 14%<sup>15</sup>. These changes would further create, across the APEC region, USD175 billion a year in additional real income (in 2004 dollars) after a 10-year adjustment period. Based on a series of case studies of reforms, the report of the project stressed that these projected gains are almost twice as large as the gains from further liberalization of merchandise trade, which it was argued, support the APEC Leaders' decision to move beyond a 'border' focused trade reform agenda to one that focuses on 'behind the border' issues. The gains discussed here come from domestic reform, and the project also considered the strategy for its successful implementation, including a 10 point checklist for structural reform.

<sup>15</sup> See Findlay (2011).

In summary, APEC has done a good amount of work related to services but this has not been recognized under the specific banner of an 'APEC services program'. Various initiatives have been and are being carried out by different APEC fora which contribute to regulatory reforms and liberalization in services sectors. Nevertheless, all the capacity building work in services-related areas, serves an important purpose of increasing understanding of services and encouraging APEC economies to perceive services sector reform to be in their own economic interest.

### **What more could APEC do**

There are emerging issues on services that APEC should discuss going forward, but there is also an important issue related to APEC's meeting structure. Work on services in APEC should address the diversified attention throughout various APEC fora without one central institutional anchor for strategy, management and reporting in order to maximize the impact and the coherence of the message or discussion or recommendations.

### ***Institutional anchor for services work***

To address the above fragmentation in the current APEC's work on services and to better monitor this work, the SOM should directly handle the coordinating work on services. The fact is that no single committee can encompass the complex, multi-sectoral issues involved in the service sector. Having these issues directly handled by the SOM would clearly signal the priority given to this important sector. A 'Services Initiative' in the SOM should have a 'report on services' as a constant agenda item in each SOM meeting where all the different groups' and committees' efforts and projects related to services are compiled and reported. The SOM is best placed to coordinate the cross-sectoral, cross-committee work that touch upon services, to draw out relevant policy messages, and to give coherence to these efforts.

The SOM's work on services should be connected with and draw upon the work of the networks of research organizations with interests in services and should develop high quality two-way channels of communication with business, both services providers and users. The annual Dialogue on Services as endorsed by the SOM and involving the Pacific Economic Cooperation Council (PECC) and the APEC Business Advisory Council (ABAC) is for this reason a valuable channel for communication with the research and business

communities. Its results would feed into the APEC discussions on trade and investment in services, and would provide opportunities to build the capacity to design and implement reform.

Services issues are not only about services trade but also largely involve regulatory reforms, as the PSU project on structural reform demonstrates. The EC should continue its work on regulatory reforms, including sectoral studies of regulations. One specific sector to highlight is financial services, specifically finance for supply chain operations. Since no specific working group is looking into supply chain finance, the EC can undertake some analytical work on this important service sector that is crucial to the supply chain, perhaps in conjunction with some of the Senior Finance Officials' Meeting (SFOM) agenda. An important issue to examine in this area is how to ensure the security of trade transactions financing within the supply chain in more APEC economies, given the absence or inadequate quality of existing commercial laws, especially in developing economies.

Since there is no one-size-fits-all template to regulatory reform, the EC's work on regulatory reforms should be supported by sector-specific regulatory reform studies and analysis. This work could be advanced by extending the set of studies in the previous work on structural reform to include work more closely related to supply chain management, such as finance as already suggested but also further work on transport and infrastructure. To complement the EC's regulatory reform agenda, sectoral groups in APEC should also be more "in-tune" with discussions that relate to the overall economic concern over the contribution of services to productivity, trade and regulatory facilitation, even as they discuss more technical issues. The sectoral studies and analysis will be important inputs for the sectoral groups' appreciation of the trade link of the issues they discuss in their meeting agenda.

On the trade aspect itself, the CTI should take a close look on services as the sector has important link or input in many of its existing programs. For example, the supply chain initiatives will be missing an important component if services are overlooked since, as discussed above, many studies have found that services support global value chains. The CTI's pursuit of connectivity, especially people-to-people connectivity touches also on a critical issue for services, i.e. mode 4 service supply or movement of natural persons. The CTI's ongoing work on non-tariff measures

should be cognizant of the fact that services barriers have a TBT (technical barriers to trade)-like effect on goods trade in so far as they impose costs on producers.

While significant attention has been directed to big service sectors like telecommunications, transport, finance, or energy, some service sectors seldom call attention, yet they are no less important for the service-manufacturing intertwining. These sectors, so-called 'sectoral orphans' like maintenance and repair services, or services incidental to manufacturing, research and development, technical testing and analysis services, rental and leasing services are increasing in their importance in 'servicified' firms. For some, these services are a source of product differentiation, if packaged along with the product that is sold. Perhaps a stocktake of barriers within APEC economies in these 'sectoral orphans' would also be helpful if APEC wants to support prevailing business models of servicification as well as promote the participation of SMEs in services in the global value chains.

### **Unresolved and emerging issues**

One very important issue for the CTI and its subgroups is investment in services. The World Trade Organization (WTO) has estimated that more than 60% of trade in services occur via commercial presence or mode 3. This means that investment issues are virtually services issues; the two are inextricably linked<sup>16</sup>. In this context, it is valuable for the CTI to check that the Investment Experts' Group (IEG) agenda has a close relationship with services and that it works closely together with other related CTI subgroups, especially the Group on Services (GOS). A once-a-year joint meeting between the two subgroups could be encouraged to promote stronger coordination.

Besides investment issues, another 'elephant in the room' is the issue of movement of natural persons (or mode 4). For servicification, mobility of service providers is crucial, and lack of available skilled manpower can curtail other competitive advantages in the manufacturing sector<sup>17</sup>. This is a sensitive and difficult issue but

<sup>16</sup> Barefoot and Koncz-Bruner (2012), op. cit., for instance, finds that in the US, multinationals account for a substantial portion of services trade. US parent companies have surplus in services trade with affiliates abroad, especially BPT services and royalties and license fees. However, US-headquartered MNCs also have substantial outsourced unaffiliated services.

<sup>17</sup> For example, a telecommunication firm's delivery model for managed services that takes over responsibility of customer's network activities, system integration and customer-support

both modes 3 and 4 are important issues for services trade and from which both developed and developing APEC economies can potentially benefit. If these two modes are not jointly addressed, APEC's work on services will lack a critical ingredient for genuine breakthrough and success.

In some cases, it makes sense to view services reform mode by mode. But studies of international business strategy suggest that businesses use all the modes of supply at the same time in their international operations. A reform approach, or the design of negotiations, which ignore this feature of business will produce outcomes which do not engage with or resonate with business. There is value in APEC considering how to design sector-based approaches to the design of reform packages and trade negotiations.

Besides modal issues, new types of service barriers are also arising and international agreements are still non-existent to deal with them. For example, issues related to cloud computing and the security of private data are important issues to tackle. APEC is, in fact, among the first international organizations to have developed a cross-border data privacy framework, but work on this remains nascent to date. Related to data privacy but not identical is the issue of unrestricted data flows (the non-localization requirements), which are important to ensure that cross-border trade in services (mode 1) can operate freely. This is especially crucial for developing economies which must rely on cross-border trade in services to be able to participate in global value chains.

The increasing use of services in manufacturing also begs the question about subsidies in services where the discipline in the services area is yet undeveloped at the WTO. Servicification can bring an unintended consequence of higher subsidy in manufacturing (through subsidies to services) and impact the competitive conditions in the goods trade. APEC can also lead the way in exploring these inter-relationships and implications for trade policy, as it has led in other issues in the past ahead of the WTO - think for instance of the environmental goods list, in which the WTO has not yet come to an agreement but APEC had already paved the way.

services, requires easy deployment of any of its qualified personnel to troubleshoot in any economy in the world. Barriers to mobility of service providers will prevent or pose difficulty to such type of business models.

Along with unrestricted data flows, data privacy, and subsidies, the issue of state-owned enterprises (SOEs) is another one that is closely linked with services as some telecommunications firms, energy, and even financial services, and others, remain in government's hands in some economies. How should APEC economies ensure a level-playing field in these service sectors assuming that they are even opened up to competition? SOEs can also distort trade in goods especially when services are sold in conjunction with goods and some service sectors are SOE-owned. This issue is closely related to the problem of subsidy in services as many SOEs are recipients of various forms of government subsidies.

Human resources development, in both knowledge-based industries and vocational areas, is another area of concern for services. The issue may be outside the purview of the CTI, and thus the SOM should oversee programs that the Human Resources Development Working Group (HRDWG) can pursue within the APEC region. As the provision of services is all about people and human talent and innovation, skilled human resources are an important ingredient in determining APEC services competitiveness. Their lack of availability can constrain services growth. Thus human resources development, along with mode 4 openness, is important to help alleviate skill shortages.

### **Call for an 'APEC Services Initiative'**

Taking up serious work on services in APEC 2014 would be a significant new beginning in APEC's economic discussions. A considerable number of programs and projects have already been carried out related to services in APEC, but these have mostly been focused on specific sectors, without an overall framework. Thus this work did not get as high a profile as other programs like, for instance, the trade facilitation initiative. Part of the reasons is the disperse character of the effort in services, with some initiatives taking place at the sectoral level or working groups, while others in APEC working groups or committees, where even there, the project is not immediately recognized as services work as such but somehow hidden under programs like 'regulatory reform' or 'behind the border issues'.

Since prior APEC services-related programs and initiatives have had no unifying banner, or common framework under which they have been treated, unlike for example the supply chain

initiative, it may be good to consider establishing a new 'Services Initiative' as discussed above. The 'Services Initiative' would be overseen directly by the SOM in acknowledgement of the cross-sectoral and cross-committee issues that require a comprehensive policy direction. This would raise both the profile and the impact of APEC's work on services for its member economies.

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