

# **Liberalization of Trade in Producer Services - the Impact on Developing Countries**

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**R 1999: 7**

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## Foreword

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This report was prepared for the Royal Ministry of Foreign Affairs. The information and views expressed in the report are the responsibilities of the authors.

Bergen, November 1999



# 1 Introduction

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Growth in international trade has outpaced growth in world output over the past 250 years (WTO 1998). Two centuries ago transportation costs were so high that high-value, low-volume goods such as spices and gold dominated trade over long distances. Since then the rate of technological progress in the transport and communication sectors has made an increasing number of products from bulk commodities to sophisticated services tradable. The recent growth of international trade in services can thus be seen as a continuation of a long-run trend towards exposing an increasing number of economic activities to international competition.

The rate of growth of international trade in services has for the past decade outpaced the growth rate of merchandise trade. An unprecedented decline in the cost of telecommunications and electronic transmission of information has stimulated cross-border trade in a number of labor-intensive services such as back-office processing of documents. Furthermore, several developing countries export skill-intensive services such as data software design and programming. Finally, multinational companies have increasingly been given access to markets previously dominated by national monopolies in providing the infrastructure and channels for cross-border trade in services, notably in telecommunications and energy services.

A development preceding the acceleration of international trade in services has been a continuous increase in services' share of total employment and nominal GDP in most middle-income and rich countries of the world.<sup>1</sup> A closer look at this trend reveals that relative growth in demand for *intermediate* services accounts for the most significant part of services' expansion relative to GDP (Francois and Reinert 1995, Klodt 1997).

The discussion around developing countries and trade in services largely revolves around developing countries' ability to *export* services. Quite often the argument is that developing countries do not possess comparative advantages in service industries and could therefore lose from liberalization. This reasoning disregards the fact that *all countries have comparative advantage*. Poor countries in sub-Saharan Africa have typically comparative advantage in primary sectors, labor-intensive manufacturing and labor-intensive services. Liberalization of trade in services will most likely result in a further increase in OECD countries' share of world output in skill-, technology- and capital-intensive services, but accompanied by an increase in developing countries' share of world manufacturing. In other words, multilateral liberalization of trade in services will help induce more rapid *industrialization* in poor developing countries. This process is driven both by a push factor and a pull factor. The push factor stems from labor-intensive industries losing out in the factor markets in developed countries and therefore

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<sup>1</sup> Whether services also have increased their share in real GDP is a disputed matter. See for example Klodt (1997) for a discussion.



consider relocating to a developing country. The pull-factor is the improved attractiveness of developing countries as investment locations if they have access to better service inputs. These are important insights largely overlooked in the discussion on trade in services.

Two thirds of manufacturing costs on average are typically purchases of intermediate goods and services. This paper focuses on the service part of such intermediate inputs, e.g. producer services. Needless to say, the quality, availability and cost of intermediate inputs are decisive for a company's productivity, competitiveness and ability to deliver on time.

The rest of the paper is organized as follows: Section 2 briefly reviews the theoretical literature on trade in services. Section 3 discusses patterns of trade in services. Section 4 presents and discusses data on the role of producer services in the economy, focusing on in South Africa, Namibia and Tanzania. Further, the experience with liberalization of trade and investment in financial services, telecommunication, and transport services are discussed. Section 5 summarizes and concludes.

## 2 Theoretical backdrop

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Trade theory predicts that all countries, rich and poor, gain from trade. Even unilateral liberalization of trade is found to be beneficial. However, benefits are unevenly distributed within a country. Furthermore, liberalization induces structural adjustments that take time and may be costly, at least to workers and owners of previously protected industries.

### 2.1 Reasons for trade and gains from trade

Theories of international trade can roughly be subdivided into two categories; classical trade theory and “new” trade theory. Broadly speaking, the classical theories postulate that countries trade because they are different and gain from trade because it gives them the opportunity to specialize in what they do best. The resulting trade pattern is one-way trade where each country exports the goods and services for which it has comparative advantage and imports the goods and services for which the trading partner has comparative advantage. The sources of comparative advantage are differences in relative factor endowments such as labor, capital, human capital and natural resources, or differences in technology. Gains from trade stem from a more productive allocation of the trading partners’ combined resources, and under most conceivable conditions all trading partners gain.

It is important to note that it is *differences* in factor endowments or technology, not absolute endowments or technology levels that matter for comparative advantage and gains from trade. Thus, even if South Africa has more both of labor, human capital and physical capital than Tanzania, Tanzania still has a comparative advantage compared to South Africa in labor-intensive industries if its labor/capital ratio is higher than South Africa’s.<sup>2</sup>

Two of the producer service sectors discussed in this paper, telecommunications and financial services, use human capital relatively intensively. Furthermore, empirical research suggests that it is more difficult to apply more low-skill labor-intensive technologies in poor countries in these industries than it is in goods-producing industries.<sup>3</sup> Countries rich in human capital thus have a comparative advantage for such services, and developing countries would probably be at the importing end of financial and telecommunications service trade. Nevertheless, they will benefit from more effective and cheaper imported services and they will be able to increase production of labor-intensive manufacturing.

Although most countries in sub-Saharan Africa are poor in human capital in the most common interpretation of the term (e.g. skilled workers and a high

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<sup>2</sup> Which to some extent explains why South African Breweries invests in Tanzania

<sup>3</sup> Blomström and Lipsey (1989) studied affiliates of US multinationals in Latin American service industries.

level of education), sub-Saharan Africa is relatively rich in a different kind of human capital – *young people*. In fact, almost half of sub-Saharan Africa’s population is under the age of 15 years. There is ample anecdotal evidence that children and youngsters have an impressive learning curve as far as computer skills and use of electronic media are concerned, even with little formal training. A young population is a resource that should not be underestimated in times of rapid technological change and relatively easy access to such technology.<sup>4</sup> It is therefore not impossible that sub-Saharan Africa will develop comparative advantage for certain human capital-intensive services in future.

“New” trade theory is motivated by the observation that, contrary to the prediction of the classical trade models, world trade is dominated by two-way trade among similar countries in similar products (intra-industry trade). Trade enables each country to exploit economies of scale through specialization in a particular variety of a good or service. Given that consumers prefer to have a choice among different brands and varieties and assuming that differentiated products are produced subject to economies of scale, trade improves welfare for consumers in all countries by offering them a broader variety of goods and services at lower cost.

We have so far discussed trade in finished products sold to the consumer. A large and increasing part of intra-industry trade is, however, trade in intermediate goods and services within multinational firms or global production networks. This adds a new dimension to trade theory since the availability, cost and quality of intermediate inputs affect the productivity of all industries that use them. The theory of trade in intermediate inputs is based on three general observations:

- A large share of a company’s cost of production is due to purchases of intermediate goods and services – the better the quality and the lower the cost of such inputs, the lower the firm’s cost;
- A high degree of specialization yields high productivity;
- A high degree of specialization requires a sufficiently large market.

A high degree of specialization requires a sufficiently large market because each producer service firm incurs a fixed cost from setting up a business and developing and marketing its unique product. A minimum sales volume is therefore required in order to break even. Hence, the larger the market, the more firms can be accommodated. The dynamics of trade between upstream producer service firms and downstream business customers amount to a virtuous circle:

- Better and cheaper inputs reduce cost in the downstream industry;
- The downstream industry expands;
- Demand facing the upstream industry increases;
- The upstream firms increase output and reduce costs;
- A larger market attracts new entrants in the upstream industry

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<sup>4</sup> The proliferation of Internet cafes in African cities indicates this.

Poor countries have too small markets to set in motion this virtuous circle. Instead, lack of specialized and sophisticated producer services renders local companies unable to benefit from world class technology and modern ways of organizing production, including the ability to participate in global production and marketing networks. Simultaneous liberalization in a number of intermediate service industries could potentially provide the “big push” necessary to set the virtuous circle just described in motion in developing countries.

Many developing countries, including sub-Saharan Africa are dominated by the primary sectors and export mostly raw materials. The primary sector, particularly the minerals sector, actually uses producer services intensively. Better access to producer services will improve the quality of commodities exported, increase the service content embodied in commodity exports and possibly the relative price of commodities. If trade barriers in the service sector were brought down, a possible effect would be to reduce further the material content of world output as a result of better quality and higher priced materials combined with the substitution away from material inputs towards service inputs (Nordås 1999).

The potential gains from trade in producer services can thus be summarized as:

1. A reallocation of resources to the sector where they are most productive in each country (without changing the productivity in each sector);
2. Improved productivity in producer service sectors that are subject to economies of scale;
3. Improved productivity in *all* sectors due to access to a broader variety, better quality and lower cost of inputs.

A seminal paper by Markusen (1989) finds that the potential gains from trade in producer services are significantly higher than the gains from trade in final goods. The reason for this is that trade in final goods only produces the first two gains listed above, while trade in producer services yields all three gains. Markusen’s prediction is supported by empirical studies. Brown et. al. (1996) for example have estimated the additional gains from a 25 percent reduction in barriers to trade in services if implemented during the Uruguay Round to be 3 times higher than the gains from the liberalization actually agreed!

To what extent liberalization of trade in services actually does provide the sufficient quality and depth of specialized producer services depends, however, on sufficient infrastructure and regulatory capacity, and on the downstream companies’ capacity to manage complex production systems or supply chains. It also depends on to what extent lower cost of inputs actually reduces the price of final goods and services. If there is insufficient competition in the downstream industry, the cost reduction could well result in higher margins instead (see Hodge 1999b).

## 2.2 Producer services and FDI

Producer services play a role in foreign direct investment both directly and indirectly. The direct impact is of course FDI in producer service sectors. Such investments accounted for 60 percent of total FDI flows in 1996, and half of the global stock of FDI at the same point in time (UNCTAD 1998). The indirect impact works through the way producer services affect the cost, quality and timeliness of production in a particular location and the role producer services play in marketing of what is produced. FDI in producer services may therefore pave the way for FDI in other sectors.

As described by Dunning (1993), foreign investors decide on where to locate their productive activities on the basis of matching their own competitive advantages with the assets and inputs a particular location is endowed with or can offer. The availability of producer services at reasonable cost, quality and variety is an important factor in this respect. Thus, multinational firms need local engineers, technicians, managers and accountants and a minimum level of social infrastructure, utilities and legal institutions. If such factors become sufficiently scarce, FDI are unlikely to materialize outside extractive industries (Honglin Zang and Markusen 1999).

FDI in infrastructure such as telecommunication and communication networks plays a role for trade in services through providing the channels for such trade. Indeed the existence of such networks, whether provided by local investors, the government or foreign investors (for example through build-operate-transfer arrangements) is crucial for whether or not a country is able to participate in trade in services through cross-border trade, FDI and servicing foreign consumers from own country.

The flow of services from infrastructure has properties of public goods. This means that once the infrastructure is in place it can be used by a large number of people at the same time. One person's consumption of the service does not prevent another person from consuming the same service, up to a point. Once the infrastructure is in place it is also difficult to exclude anybody from using it, although this has become easier with new technology. Services that are provided over a network call for government intervention. Traditionally, infrastructure services have been provided by parastatal monopolies, but privatization of such services is now one of the most important driving forces for foreign direct investment in many poor countries. Successful privatization involving private firms that command state of the art technology does, however, require government capacity to design and enforce regulation. It is of particular importance to make sure that service providers get access to the infrastructure and competition among them prevails. This is usually obtained by splitting the provision of the network and the provision of services in different companies and ensuring competition among the latter type of companies.

FDI is one of several possible ways of servicing a foreign market. Firms choose between commercial presence and cross-border trade based on, among other things, the relative importance of economies of scale and transport costs.

If international trade is subject to significant transport costs, industries will locate in the largest market in order to exploit economies of scale while at the same time economize on transport costs (Krugman 1980). Furthermore, the virtuous circle explained in the previous section implies agglomeration of producer service firms in large markets due to pooling of inputs (Krugman and Venables 1995). Depending on the relative importance of economies of scale, vertical cost-linkages between firms and transport costs, firms will choose to service a market through commercial presence or cross-border trade. For a wide range of services, cross-border transaction costs are probably more important than economies of scale, and the preferred mode of servicing foreign markets is commercial presence.

Human capital intensive service sectors such as telecommunication services, financial services, engineering services and other business services appear to be subject to economies of scale. Economies of scale stem from fixed costs related to product, process and organizational innovation. Such costs are incurred at the firm level, usually at the headquarters of the firm. The resulting innovations can then be applied at little additional costs in all the branches and affiliates of the firms.<sup>5</sup> These producer service industries are therefore increasingly dominated by large and very large multinational enterprises which recently also have entered sub-Saharan African economies.

Foreign investors largely face the same constraints as local investors, and FDI in producer services will probably be slow to respond to liberalization in poor countries with small markets. Namibia has for example experienced that in spite of liberalizing the financial and telecommunication sectors, little FDI has materialized (CAPAS 1998). Foreign investors may, however, have lower costs than local firms. Furthermore, regional agreements may open the possibility that foreign investors service an entire region from one location in the region.

## 2.3 Regional approaches to trade liberalization

Countries within a region are more likely to trade with each other and are more likely to have similar standards, tastes and culture. Therefore, harmonization of regulations, which is often necessary in order to facilitate trade in services, is more likely to be successful in a regional context, it is argued. Hoekman and Sauve (1994) have studied a number of regional agreements, mostly among developed countries, and found that they are largely complementary to global liberalization. NAFTA entails the most comprehensive agreement of service trade liberalization achieved to date. This is an agreement between the US, Canada and Mexico, and indicates that comprehensive liberalization and harmonization of regulation and standards are possible even between countries at highly different levels of development. To what extent a regional approach is a fruitful first approach to liberalization of trade in services in sub-Saharan Africa is more uncertain. As opposed to regions in the developed world, intra-regional trade is actually a small share of total trade in sub-Saharan Africa. This is probably a result of trade patterns

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<sup>5</sup> Blomström and Lipsey (1989) find that branches and affiliates of US multinational service firms had a much more similar technology in their Latin American affiliates than manufacturing multinationals.

with specialization according to comparative advantage, where sub-Saharan African countries to some extent have comparative advantage in the same, mainly primary industries and therefore trade with the OECD countries. In addition, insufficient intra-regional infrastructure limits trade and transportation. The region includes war-torn countries such as Angola and the Democratic Republic of Congo, which lack the most basic conditions for trade in services. Nevertheless, harmonization and liberalization could at least go some way in creating a regional market among the more stable economies in the region for foreign investors in the service industries, facilitating the exploitation of economies of scale.

## 2.4 Global production and marketing networks

Modern industries sell their products and purchase their inputs from all over the world. Furthermore, there has been a trend towards a shift in market power from producers to retailers for a broad range of consumer products (Gereffi 1999). The retailer typically invests in brand names and leaves production to a network of contractors and sub-contractors. Wal Mart, Ikea and other multinational retailers manage such decentralized global production and marketing networks where developing countries typically assemble the products.

During the late 1990s we have seen massive structural changes within the retail sector, including a number of multi-billion dollar cross-border mergers and acquisitions. Retailer-led supply networks constitute a very competitive market where timely delivery according to quality specifications is crucial. A minimum standard of services such as transport, communication and finance at reasonable cost is decisive for participation in such networks. Furthermore, as the retail sector in developed countries become more concentrated, it is increasingly difficult to enter these markets outside the established marketing networks.

The international supply chains just described are most prominent in consumer goods sectors. In more capital-intensive sectors such as the automotive sector and the computer industries, the supply chains are producer-driven and tend to be more regional in scope (Gereffi 1999). Sub-Saharan Africa does not have a significant industrial base in the producer-driven type of supply chains. The region is therefore more likely to be integrated into the retailer-driven supply chains, which are more global in scope, somewhat less producer-service intensive, but still require a better access to such services than what is commonly found in the poorer sub-Saharan African countries at present.

To summarize, trade theory states that countries are richer the better they are endowed with productive resources and the more efficient productive resources are utilized. Furthermore, efficiency increases when countries, companies and individuals are able to specialize in what they do best. International trade facilitates such specialization. However, the more specialization, the more transactions are needed in an economy. If transaction costs are high due to poor infrastructure or technical or political barriers to

trade, the scope for specialization and participation in regional, global and in some cases even national production networks is limited and may result in stagnation if the local market is small.



### 3 Patterns of trade in services

Table 1 below shows the *cross-border* trade flows of services for different groups of countries. We have also estimated revealed comparative advantage for service trade for each group of countries.<sup>6</sup> It is clear that industrial countries have a comparative advantage in service trade. At this level of aggregation there is two-way trade in services in all regions, e.g. all regions both export and import services. At a more disaggregated level, however, one-way trade tends to be more prominent the poorer the country. Typically, poor countries will import skill-intensive and technology-intensive services and export labor-intensive services, while developed countries trade different varieties of the same services among themselves. This is illustrated by the trade pattern in two neighboring countries, South Africa and Namibia presented in table 2.

Table 1: Patterns of Cross-border Trade in Services (1996)

	Share of World Exports	Share of World Imports	Trade Balance (\$b)	Revealed Comparative Advantage
Industrial Countries	70.3	67.8	34	1.06
Developing Countries	29.6	31.4	-23.5	0.84
Africa	1.5	2.5	-14	0.79
Asia	15.4	15.4	0	0.78
Europe	5.6	4.6	12	1.35
Middle East	2.7	4.2	-20	0.74
Americas	4.5	4.7	-1.5	0.89

Source: IMF Balance of Payments Statistics 1997

Table 2: Cross-border trade in services for South Africa and Namibia

	South Africa		Namibia	
	Imports	Exports	Imports	Exports
Services	5 942	5 975	473	242
Utilities	5	44	0	0
Construction	25	9	20	1
Tourism	1 563	2 224	54	208
Transport services	2 656	1 998	189	0
Communication services	272	208	0	8
Financial services	319	686	33	3
Business services	386	323	133	4
Government services	45	113	12	13

Source: Hodge (1998), Nepru (1998a)

<sup>6</sup> Revealed comparative advantage refers to the share of the region in total world exports of services relative to the share of the region in total world exports. If the ratio exceeds unity, the region has a comparative advantage for services.

South Africa is a much larger economy than Namibia and also significantly richer in terms of GDP per capita. For Namibia, exports of services arise almost entirely from tourism. Namibia's participation in service trade appears to be explained by the classical theory of trade with specialization according to comparative advantage and one-way trade. In contrast, South Africa has considerable two-way trade indicating that its participation in international trade in services to some extent can be explained by the new theories of trade driven by product differentiation and economies of scale. This two-way trade is, however, partly deceptive. This is because South Africa has a positive trade balance with the Southern African region within which South Africa has a comparative advantage in producer services, while it has a negative trade balance with the industrial countries. However, product variety and economies of scale has allowed two-way trade to take place even with industrialized countries.

It is important to note that exports of services for poorer nations may be highly significant to their economies, as figure 1 shows. It compares the flow of non-factor services as a percentage of GDP for four countries; Namibia, South Africa, Tanzania and the US. In Tanzania, non-factor service exports have actually averaged as much as close to 80 percent of merchandise exports over the last five years, consisting mainly of tourism and services related to transit transport to land-locked neighboring countries.

Figure 1



Source: IMF (1998)

Patterns of trade through *commercial presence* are very similar to those of cross-border trade. Industrial countries dominate not only as a source of FDI, but also as a destination for FDI in services. Low-income countries do not export services through FDI. However, middle-income countries are

beginning to participate in the export of services through FDI. The majority of these investments is in other developing countries. A case in point is South Africa. South African cellular telephone companies are now active in five other African countries. In financial services, there have been 35 FDI deals in the last 5 years, while a South African satellite broadcaster is the dominant broadcaster in Africa. South African leisure companies have invested in tourism throughout Africa and South African retailers are active in most Southern African markets. There is also some FDI in industrial countries as SA information technology firms have made a presence in Europe and Australasia.

## **4 The role of services – empirical evidence**

The growing share of services in national output and employment has been most evident in the developed economies, where growth has been fastest in intermediate demand for services (Klodt 1997). This has been largely attributed to the changing structure of production driven by a dynamic interaction between market expansion and innovation. The manufacturing sector has become more technology-intensive and flexible in response to consumer demands, while improved quality and a broader variety of service products have been made available to manufacturing largely as a result of developments in information and communication technologies (Hodge 1999b). Empirical evidence also suggests that the trend towards outsourcing - a popular reason put forward to explain the growth in services - has contributed very little towards the rise of services (Francois and Reinert 1995). In the following, we analyze the particular role of financial services, telecommunications and transport focusing on Namibia, South Africa and Tanzania. The United States are included as a benchmark.

### **4.1 Financial services**

Several studies have found a strong positive correlation between expansion of financial services and long-term economic growth. The most quoted study is King and Levine (1993) who found that development of the financial sector precedes faster economic growth. Furthermore, it has been found that trade in financial services improves the performance of the financial sector in countries that open up to such trade (Das 1998).

#### *Role in the economy*

Joseph Stiglitz coined the metaphor of the financial system being the 'brain' of the economy because of its role as the allocator of capital resources. He argued in a recent speech:

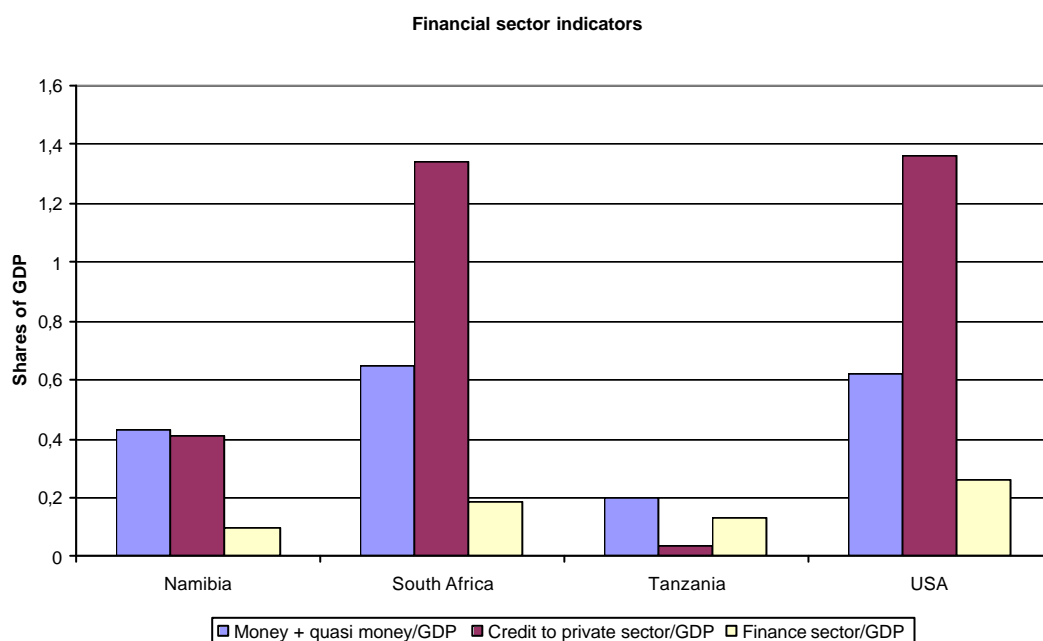
Well-functioning financial systems do a very good job of selecting the most productive recipients for [capital] resources. In contrast, poorly functioning financial systems often allocate capital in low-productivity investments. Selecting projects is only the first stage. The financial system must continue to monitor the use of funds, ensuring that they continue to be used productively. In the process, it serves a number of other functions, including reducing risk, increasing liquidity, and conveying information. All of these functions are essential to both the growth of capital and the increase in total factor productivity.

The management of risk is another crucial role for the financial system. As intermediates between savers and investors, the financial system needs to manage risks from maturity mismatches, currency mismatches and credit risk.

Poor management of risk exposes a country to potential banking crises which can be extremely costly to resolve and can stunt growth for many years afterwards. Aside from the economy-wide importance of an efficient financial system, individual users benefit from lower funding costs, lower transactions costs and a more diverse funding base (Butterworth and Malherbe 1999).

Production of financial services is intensive in its use of human capital, physical capital and technology (in particular, information and communication technologies). These characteristics favor production in industrial countries, and is reflected in a higher direct contribution of financial services to GDP and employment in developed economies and a greater level of efficiency in production, as figure 2 indicates. It depicts some indicators of the depth of financial markets and the role of the financial sector in the economy for South Africa, Namibia and Tanzania, shown against the US benchmark in 1997. Notice that South Africa has a similar depth of its financial markets as does the US, while in Tanzania it appears that the financial system does not fill the function of allocating resources to productive investments. This is in contrast to Namibia where the financial sector plays a far more important role in the allocation of capital.

Figure 2



Source: IMF (1998)

A useful indicator of the level of competition and efficiency of the financial sector is the spread between lending rates and borrowing rates. Lower spreads suggest greater levels of efficiency and more competition for intermediation services. Table 3 below gives the spreads for the four countries being discussed. It is clear that even if one adjusts for risk, spreads in Tanzania are way out of line with the others - suggesting an inefficient and uncompetitive sector.

Table 3: Lending Spreads in Financial services (Jan 1998)

	Tanzania	Namibia	South Africa	USA
Spreads	20.6	7.2	4.7	3.0

Source: IMF International Financial Statistics 1998

### *Experience from reform*

#### **South Africa**

South Africa's re-entry into the global markets for financial services was as much a result of changes in policy *towards* South Africa as liberalization within South Africa. The country already had a fairly liberal policy framework. In addition the financial sector was and still is one of the most advanced sectors in the South African economy compared to world best practice. Thus, while weaknesses in the financial sector led to crisis in the East Asian newly industrialized economies, South Africa by and large avoided a contagion effect.

Liberalization of trade in financial services has mostly been related to commercial presence. South Africa has not opened to cross-border trade in financial services and there are restrictions on foreign banks operating in South Africa as well. The most significant are capital controls on the capital account of the balance of payment, regulation that effectively closes foreign banks out of the retail banking market,<sup>7</sup> and the prerequisite that capital requirements must be held in South Africa. Foreign banks can enter South Africa by establishing a representative office, a branch or a subsidiary. They have to establish a separately capitalized branch or subsidiary in order to take deposits, become authorized foreign exchange dealer or become a primary dealer in government securities. At present 12 foreign banks have branches in South Africa, 58 have representative offices, but there are no foreign subsidiaries.<sup>8</sup> Foreign investors have also penetrated the South African market in broking, short-term insurance and investment banking. Most of them service the rest of the SADC region from South Africa.

Since the early 1990s, when the re-integration into world markets gained momentum, the financial sector has been the second fastest-growing sector of the economy, accounting for a quarter of total growth in the economy, although the financial sector itself accounts for 16 percent of GDP.<sup>9</sup> Employment in the financial sector has increased by 20 percent since 1990 (Butterworth and Malherbe 1999), while other sectors have shed labor. Further, South African financial sector firms have rapidly ventured into foreign markets. South African banks have established a presence in most

<sup>7</sup> Foreign banks may not hold bank accounts for natural persons unless a minimum balance of R 1 mill. is retained on the account at all times.

<sup>8</sup> A branch has the same international credit rating as its parent company, while this is not the case for a subsidiary.

<sup>9</sup> Financial services, insurance, real estate and business services are aggregated into one sector in the national accounts and it grew by 4.4 percent annually on average during the period 1994-98, while the fastest growing sector was transport, storage and communication, which grew by 7.1 percent on average during the same period.

southern African countries that have opened their markets to foreign banks. Furthermore, Old Mutual, the country's largest insurance company has demutualized and listed on the London stock exchange.

A study by Butterworth and Malherbe (1999) concludes that foreign entry in the South African financial sector has accelerated innovation, increased product choice and improved standards. Further, they argue that since the rapid pace of innovation in the financial sector is spread along global networks, it is imperative to the South African financial sector to be part of this network. Finally they emphasize that new technologies, particularly the Internet, call for new rules governing cross-border trade in financial services.

### **Namibia**

Namibia has also undertaken steps towards liberalization of the financial market. The country has a relatively sophisticated financial system, to a large extent integrated with the South African market. This is partly because of the Common Monetary Area but also because of SA occupation of Namibia until independence in 1990. The strong presence of South African-owned subsidiaries ensures that the Namibian banking sector benefits from the technological advancements at relatively lower costs (Nepru 1998b). Namibia uses SA facilities for inter-bank cheque clearing, use of SWIFT for international transactions and has access to SASWITCH which provides access to ATM and credit card facilities worldwide.

However, the dominance of South African banks has had negative effects on the level of competition in the Namibian financial sector. Despite dropping all formal barriers to entry into the sector, only one indigenous bank<sup>10</sup> and no foreign banks have established themselves in competition. Alleged anti-competitive practices against the new bank, CSIB, included exclusion from the SA Association of Commercial Banks facilities to clear its cheques and initial exclusion from the Bankers Association of Namibia. Spreads are 2.5 percent higher in Namibia relative to SA (see table 3), and rates of return on assets are almost double (NEPRU 1998b). The suggestion being that South African operators are not competing fiercely and have adopted a risk averse strategy to lending. This then limits the extension of credit in Namibia as large parts of the population and business get excluded from intermediation services.

The rest of the Namibian financial services sector has similarly dominant links with South African intermediation firms. Even the Namibian Stock Market benefits from dual listings on the Johannesburg Stock Exchange. It is possible that a strong SA presence acts as a deterrent to other foreign entry which would bring about greater competitive gains.

### **Tanzania**

Tanzania started a thorough reform- and liberalization process in 1991. The foreign exchange market was gradually liberalized from a fixed exchange rate regime combined with heavy foreign exchange control, to a managed float and the establishment of foreign exchange bureaus. Regulation of interest rates

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<sup>10</sup> This bank was subsequently bought out by Malaysian investors

were gradually eased and removed. Private local and foreign banks were allowed to enter the market, and 16 foreign banks, 9 foreign non-bank financial institutions and one local bank have since been licensed to do business in Tanzania. To date, two of the foreign banks have run into financial problems and closed down.<sup>11</sup> The state-owned and previously only significant commercial bank in the country, the National Bank of Commerce was broken into two units, restructured and recapitalized.

During the reform process, the Bank of Tanzania ran a very tight monetary policy in order to curb inflation and mop up excess liquidity. The immediate effect of the policy changes was a credit crunch. Credit to the private sector plunged from 14.6 percent of GDP in 1991 to less than 3 percent in 1997. During the same period, real fixed capital formation declined by 6 percent annually on average. Thus, it appears that the financial sector is mainly concerned with portfolio investments in financial assets such as foreign exchange and treasury bills.

The bold reforms have stabilized the economy, improved confidence and stemmed and probably reversed capital flight. Foreign direct investment, although still very small compared to overall GDP, has increased from next to nothing in 1990 to close to 160 mill. USD in 1997.

Further progress from stabilization to sustained growth depends crucially on the financial sector's ability to take up the other functions mentioned above, notably allocating resources to viable investment projects, monitoring of performance and information conveying.

The experience of these three countries clearly shows that in order to take advantage of liberalization and reform, a sound institutional framework for regulation needs to be in place. In South Africa, this criterion has largely been fulfilled, in Namibia there has not been sufficient competition to ensure an effective financial sector, while in Tanzania, the market has been too small and shallow to accommodate diversified financial services. In addition, the institutional framework is probably still too weak for a market for long-term credit to be established.

## 4.2 Telecommunications

Telecommunications have been seen as the classical example of a natural monopoly due to huge fixed costs and very low marginal cost of services. Therefore telecommunications have been provided by a parastatal monopoly in most countries. There are also other market imperfections related to telecommunications. Network externalities is one such imperfection and it means that the value of the network is larger the more participants it has. Obviously, a telephone or fax machine is only useful to a person or a firm if the people they want to communicate with also have a telephone or fax. These externalities necessitate regulation in order to ensure access to the

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<sup>11</sup> The first case was Meredien Biao Bank Tanzania in 1995. The latest case is Greenland bank in 1999.



services at the lowest possible costs. Nevertheless, technological developments and organizational innovations have improved the functioning of the market and introduced regulatory mechanisms that improve rather than replace the market. The role of government has thus increasingly shifted from providing telecommunication services to regulating the industry.

Telecommunications are the key sector for a country to benefit from the information technology revolution. Entire industries are based around the existence of communication services and would not exist otherwise. Furthermore, developments in information technology have led to new ways of organizing production. The Internet has created a virtual market place providing endless opportunities for developing countries. It provides easy access to marketing networks and information and it is a channel for trade in all services that can be digitized. Furthermore, information is an increasingly important factor of production. However, the realization of the opportunities new communication technology brings, depends on telecommunication infrastructure.

### *Role in the economy*

As with financial services, production is intensive in its use of human capital, physical capital and technology. The density of demand impacts costs as physical infrastructure needs to be laid out. However, this type of scale is becoming less important with new technologies, especially mobile telephony (Hodge 1999a). All these factors favor production in more developed economies. In addition, a rapid rate of technological change in telecommunications means that the productive and dynamic inefficiencies of state monopoly supply are extremely large, and gains from reform likewise.

Table 4 demonstrates the wide variety in the level of telecommunications infrastructure in various economies and the relative level of efficiency in production. Poorer countries obviously have lower rates of penetration due to the lower income levels. However, part of the reason for low penetration is also relatively poor efficiency in poorer countries. This is evident in the rather crude measures of the number of faults per line and the number of lines per member of staff where there is a clear relationship between development status and relative efficiency. Prices reflect efficiencies to, after accounting for differences in the prices of immobile factors of production. Tanzanians pay 50 percent higher connection charges and 11 percent higher local call rates relative to the USA despite having less than 1 percent of the purchasing power. In comparison to other developing countries, Tanzania still comes out poorly with higher connection and call charges than both Namibia and South Africa. Bearing in mind the purchasing power of a Tanzanian company, household or public institution, the costs of telecommunications are a heavy burden on Tanzanian firms' competitiveness.

Table 4: Indicators of telecommunication performance (1997)

	Tanzania	Namibia	South Africa	United States
GDP/capita (\$)	244	1855	2978	30172
Main Lines per 100 people	0.3	5.8	10.7	64.4
Cell phones per 100	0.06	0.8	3.7	20.7
Lines per staff member	22	55	80	187
Faults per line	175	76	66	13
Connection charge (\$)	66.70	54.90	37.10	43.70
Cost of 3 minute local call (\$)	0.10	0.04	0.07	0.09
PCs per 1000 people	1.6	18.6	41.6	406.7
Internet hosts per 10 000 people	0.04	4	34	976

Source: ITU Yearbook of Statistics 1999

Different regulatory regimes can have an impact on performance. Wallsten (1999) finds that privatization, competition and conduct regulation together contribute to improved performance in telecommunications given similar country characteristics. A further difference is the relative density of demand. This is apparent in the comparison of South Africa and Namibia. The two countries are not very far from each other in terms of income per capita, yet Namibia is lagging far behind South Africa. Namibia is a very sparsely populated country, while South Africa has a much larger population and is more urbanized. Telecom Namibia estimates that the cost of installing a line in 1998 was \$1200 in a city, \$5000 in a rural cluster and >\$20,000 for an isolated rural subscriber (NEPRU 1998c). However, small, sparsely populated countries can in many cases benefit from scale economics through regional cooperation or different technologies.

However, connection and call costs are only one aspect of the actual cost of quality-adjusted services. At present it typically takes a year to get a telephone installed in some southern African countries. It is difficult to get a telephone or a connection repaired, and getting an international line can be very time consuming. Consequently, businesses often resort to expensive satellite solutions despite the higher costs.

### *Experience from reform*

In all the countries concerned reform has been faster and more comprehensive in the mobile telecommunication market than in the fixed line market. This is probably because there are usually no incumbent national company in the mobile market. Obviously, it is easier to introduce a liberal market regime in a new market than to deregulate and liberalize an existing market with its vested interests. In all three countries under consideration, a mobile telecommunication market open to private, foreign participants have been introduced during the 1990s. However, in Namibia no private company has applied for license. In South Africa mobile cellular communications was introduced in 1994. There are two competing network providers, and a third license is up for tender. One of the two established network providers is owned by Telkom and Vodafone UK, while the other is owned by local

interests.<sup>12</sup> The network providers in turn are vertically linked to a number of retailers. Since the mobile market was opened, it has grown by about 50 percent annually. The network covers most of the country (Hodge 1999a). The liberalization efforts in fixed line services so far has largely concentrated on liberalizing domestic regulation, which is a necessary first step towards trade and investment liberalization. Namibia, South Africa and Tanzania have all introduced a regulatory body for the telecommunication industry, but only in South Africa is the regulatory body independent.

In all three countries one company still has monopoly on fixed line services. However, all countries plan to privatize this company and open up to competition. Tanzania plans to privatize TCCL, the state-owned monopoly by the end of the year 2000 and has already invited selected prospective partners to express interest. But only South Africa has so far actually partly privatized its fixed line service provider, Telkom Ltd. A 30 percent stake in Telkom was sold to a consortium consisting of SBC (60 percent) and Telekom Malaysia (40 percent) in 1997. Telkom has retained monopoly on fixed line services, but competitors will be allowed from the year 2002. So-called value added services have already been opened to competition.

The partial opening of the telecommunications industry has brought significant benefits for the South African economy already. The licensing of new products - specifically cellular and VANS - has created large numbers of jobs, including low-skilled jobs in the retail sector<sup>13</sup>. In fixed line telephony there has been an improvement in productivity, service quality and a re-balancing of tariffs which has reduced the price of international calls but increased the cost of local calls. Part of this can be ascribed to increasing competition from the cellular industry, and some can be ascribed to the transfer of technology from the foreign equity partners. This has had a cost in terms of employment loss but which is dwarfed relative to the expansion of jobs in cellular and VANS. Further, there has been a growing investment in human capital since foreign entry. It has also provided necessary capital for network expansion, aiming to double the tele-density of the country in 8 years.

However, the extension of the fixed line monopoly has prevented a reduction of the price-cost margins. Furthermore due to the retained monopoly, significant inroads into the productivity gap with leading international providers are yet to be made. Price-capping has not provided an alternative disciplining effect because it has been set at a non-binding level. While there has been some competition from the cellular market, this has focused on service rather than price. A significant reason for this is the cross-holding in one of the two providers by the fixed line monopolist. The result is that South Africa is estimated to have one of the highest cellular call rates internationally<sup>14</sup> and fixed line prices have not seen the dramatic drops that characterized liberalization in other countries. This has limited downstream

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<sup>12</sup> Cable & Wireless UK had a stake in the other network, but sold out to a local group.

<sup>13</sup> Retailers selling air-time, phones, computing equipment and software.

<sup>14</sup> This is based on purchasing power parity.

effects on other industries to the availability of new products and improvements in quality - no significant price effects.

Liberalization of the telecommunication sector has introduced an incentive and an opportunity for South African telecommunication firms to enter foreign markets. The mobile network provider has already invested in a number of African countries (Rwanda, Swaziland and Uganda) in cooperation with local partners. In Uganda the main partner is Telia of Sweden. Telkom is active in privatization bids in a number of African countries. Its strategy is to become a prominent provider of telecommunication services in Africa in order to exploit economies of scale and improve international competitiveness (Hodge 1999a). The expansion abroad is undertaken jointly with Telekom Malaysia who has a stake in Telkom.

Experience from reform in the telecommunication sector is similar to those of the financial sector. The liberalizing country gains if it has established an institutional framework that is capable of providing a transparent and competitive environment, and the local market has a sufficient scale to attract investors.

### 4.3 Transport

The transport sector includes road, rail, air and maritime transport. The quality, availability and cost of transport services have a direct impact on the cost of trade and the opportunity to participate in global or regional production networks (see section 2.3). International production networks are increasingly important and requires that participants are able to deliver the agreed quantity and quality at the agreed time. In such an environment the efficiency of the infrastructure becomes crucial to linking up with the network, while failure to provide a minimum standard excludes a country from participation in the network. Providing this minimum standard is relatively more expensive for low-income countries with a low density of demand, and for sparsely populated, land-locked countries in particular.

There are numerous studies demonstrating the importance of transport costs to growth. Table 3 shows the results of a study by Fay (1996) on the social return to investments in transport infrastructure. Rates of return are high for all countries, but highest for middle-income countries where marginal improvements make a significant difference to the quality of infrastructure and where business is sufficiently developed to take advantage of the improvement.

Table 3: Rate of return on transport infrastructure investment

	Transport
Low-income countries	0.39
Middle-income countries	0.71
High-income countries	0.42
All countries in sample	0.56

Source: Fay (1996)

Some idea of differences in transport costs between countries can be attained by looking at the CIF-FOB band on imports which gives the percentage contribution of shipping costs to overall costs. These average 2 percent of imports for industrial countries, rising to 5 percent for developing countries. However, caution must be sounded about strong conclusions over efficiency as these figures also reflect differences in the average distance to the trading partner.

The performance of the internal transportation system is as important as external transport links. Gelb (1999) notes that “with unit costs up to three times world levels, transport poses a critical barrier to internal economic integration [in Africa]”. He continues to note that while transport costs have fallen continuously in the rest of the world, transport costs have tended to rise in Africa.

Transport networks can to a large extent be considered as public goods. Therefore, transportation infrastructure has traditionally been provided by government or parastatals, and transportation services have been heavily regulated. However, numerous countries have begun to deregulate aspects of the sector over the last 20 years - with the most popular being air and rail transport. In the three countries considered in this study, however, transport has not seen significant reform as yet.

Throughout this section we have pointed to obstacles to developing countries taking full benefit of the opportunities trade liberalization introduces. We close the section with a closer look at adjustment costs and preconditions for benefiting from liberalized trade in services.

#### **4.4 Implementation Issues for developing countries**

Concerns about adjustment costs are much greater in service sector liberalization than liberalization of merchandise trade. This is partly because reforms are harder to reverse once started, but also because they involve key sectors of the economy that can have a profound impact on the workings of the entire economy. The most critical of these is the financial sector, where liberalization needs to be preceded by macroeconomic stabilization and supported by prudential measures. As Tanzania's experience has shown, the adjustment costs could amount to a credit crunch over an extended period of time.

The service markets discussed in this section are subject to a number of market imperfections. Liberalization of trade in the communications, transport and utilities sectors therefore first requires that these sectors are opened to competition through a variety of pro-competitive regulatory reforms. The general principle behind such reforms is to separate the market for network infrastructure from the market for services provided over that network. License auction combined with price-capping and non-discriminatory access requirements are used to effectively regulate the network component, which is subject to the most severe market imperfections. The service provision

component is then opened to full competition, however with a strong need for oversight by the competition authority.

However, it is not just structuring the reform that is complex, it is also the continued regulation of conduct after reform has taken place to ensure that anti-competitive practices do not occur. Structure and conduct regulation requires considerable regulatory capacity - capacity which many developing countries may not have.

Alexander and Estache (1999) argue that the impact of gains from regulatory reform depend on how they are shared which in turn depends on the effectiveness of regulation and competition. Ineffective regulation and competition does not result in lower prices but higher profits, benefiting the owners of capital which are likely to be foreign firms in a more liberal environment in low income countries. The telecommunications reform in South Africa is a good example of how merely opening telecommunications to foreign participation but not competition results not in lower prices but higher profits for the incumbent and foreign partners (Hodge 1999a).

The most prominent area of adjustment costs is likely to be in the labor market. Parastatal service providers have traditionally been a source of social employment in developing countries. Therefore the quickest source of efficiency gains for market driven firms is to shed labor. For example, in Argentina the electricity distribution companies shed up to 40 percent of employment over 30 months (Alexander and Estache 1999). However, as the experience in the South African financial and telecommunications industries have shown, liberalization can also lead to rapidly growing demand for workers.

In developing countries with low stocks of human capital, increases in demand for skilled labor may outstrip existing supply. This may result in both impediments to further investment in the liberalized service sector and wage inflation amongst the skilled workforce. Wage inflation could see many of the efficiency gains from liberalization accruing to skilled workers at the expense of lower prices (Hodge 1999b).

To conclude this section, gains from trade liberalization are constrained by regulatory capacity, and scarcity of infrastructure and skills. There are also a number of distributional issues that needs to be addressed. It should, however be remembered that it is the present structure of key service industries that has rendered the markets - and to a large extent the economy as a whole - in sub-Saharan Africa in the present sorry state in the first place.

## 5 Implications for developing countries, summary and conclusions

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Sub-Saharan Africa is likely to participate in world trade on the basis of comparative advantage. Liberalization of trade in services will therefore most likely result in continued one-way trade and a widening of the trade deficit in producer services. However, there are also export opportunities in labor-intensive services open to poor countries. If the relatively labor-scarce economies of the world open up to trade in mode 4, movement of natural persons, sub-Saharan Africa will be in a better position to exploit their comparative advantage in labor-intensive service sectors.

Other good news is that liberalization of trade in services provides the opportunity to reduce the deficit or widen surplus in merchandise trade.<sup>15</sup> This happens when labor-intensive and natural resource-intensive manufacturing industries relocate to developing countries, including sub-Saharan Africa. Thus, the possible and likely outcome that developing countries will become more *industrialized* as a result of liberalizing trade in services is a point that is overlooked if the analysis is limited to the service sectors alone.

The magnitude of the gains from liberalization depends on developing countries' ability to participate in supply chains, the quality and availability of infrastructure and the capacity to improve and enforce regulation. Availability of infrastructure is of particular importance. It is an essential input in the production process and the workings of a modern economy. If production or transactions are disrupted by power-cuts and down-time of computer or telecommunication networks, this will reduce the return to investment substantially and in many cases render the introduction of modern technology through new investments unprofitable.

Much of the access to sophisticated producer services from industrial countries will occur through commercial presence, if at all. Therefore, it is important for developing countries to create a suitable environment for foreign investment. This does not necessarily entail offering tax incentives, but rather involves offering a stable macroeconomic environment and a predictable policy environment. In addition, amongst regulated service sectors where sunk costs of establishment are large, there needs to be regulatory certainty before foreign firms are going to enter the market. A longer list of requirements would include access to physical and human capital, the repatriation of profits and a strong legal system.

To summarize, it appears that a diversified producer service sector emerges when an economy has reached a middle-income level and has accumulated a

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<sup>15</sup> South Africa has a trade surplus in merchandise trade while Tanzania, Namibia and the US run a deficit on the merchandise trade balance.

sufficient stock of human capital. Nevertheless, access to a range of high-quality producer services is necessary for a country to participate in the ongoing globalization process characterized by global (or regional) production networks and supply chains. The forthcoming GATS negotiations provide an opportunity for poor countries to link up with the global trading system even when they do not have local companies with the capacity to supply diversified and sophisticated producer services. Consequently, the gains from liberalization stem not only from export opportunities in the service sectors subject to liberalization. These gains are probably not even the most important for poor countries. Rather, the most important gains stem from improved productivity and the ability to exploit existing comparative advantage. This implies that poor countries will produce a larger share of world output in *manufacturing*. In this process it is important first, to focus on barriers to trade and investment in services stemming from local regulation and weak capacity to enforce a transparent regulatory system in poor countries. Second, the OECD countries must open their markets to imports from developing countries both in primary sectors and resource- and labor-intensive industries. OECD countries should also refrain from preventing such industries to relocate to developing countries through subsidies or other incentives.



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# Summary

This paper analyzes the impact of liberalization of trade in producer services, focusing on financial services, telecommunications and transport. The likely effects on developing countries is that they will become net importers of the liberalized services, but they will also become more industrialized and increase their exports of labor-intensive goods and services, if given market access under the most appropriate modes of trade. Potential gains from this pattern of trade are large, since imports of efficient producer services will improve productivity in all sectors of the economy and depends on the developing countries' capacity to ensure sufficient competition in the liberalized sectors, and the quality of infrastructure in the country in question.

The paper continues with a discussion of the experience from liberalization in the financial and telecommunication sectors of South Africa, Namibia and Tanzania. South Africa has apparently gained the most from liberalization, as its markets are sufficiently large and reasonably well regulated to attract foreign investors. Namibia has seen very little foreign investment after liberalization, while Tanzania has attracted investors that have established themselves in the most profitable niches of the markets.

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