

# COMMONWEALTH TRADE POLICY DISCUSSION PAPERS

**The Services Trade Dimension of Global Value  
Chains: Policy Implications for Commonwealth  
Developing Countries and Small States**

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### Abstract

This paper considers in detail the various factors that drive competitiveness in services, a critical but often overlooked part of the global value chain, and the policy levers available to influence them. Services play a key role in enabling the development of value chains in goods, through transport, telecoms, logistics etc., and are now creating global value chains in their own right. In value-added terms, services now account for nearly half of world trade, yet too few Commonwealth developing countries are taking advantage of the new opportunities available. The paper concludes with a number of policy recommendations to increase country participation in the services aspects of global value chain activity.

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## Abbreviations and acronyms

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APEC	Asia-Pacific Economic Cooperation
BPO	Business Process Outsourcing
CRM	Customer Relationship Management
EAC	East African Community
ERM	Enterprise Resource Management
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GVC	Global Value Chain
HRM	Human Resource Management
ICT	Information and Communications Technology
IDE/JETRO	Institute of Developing Economies/Japan External Trade Organization
ITeS	Information Technology-enabled Services
ITO	Information Technology Outsourcing
KPO	Knowledge Process Outsourcing
LPI	Logistics Performance Index
MNC	Multinational Corporations
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
R&D	Research and Development
RCA	Revealed Comparative Advantage
SME	Small and Medium Enterprises
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

## Summary and recommendations

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Services are a critical but often overlooked part of the growing global value chain (GVC) phenomenon.

First, services play a key role in enabling the development of value chains in goods. Advances in telecommunications and information technology have made GVCs in goods possible by allowing for the segmentation of production into units that can be dispersed geographically and yet be connected. Services inputs provide the 'link' or the 'glue' at each point of the chain, without which it could not happen (for example, transport, telecoms, logistics, distribution, marketing, design and research and development).

Second, services industries are now creating GVCs in their own right. For many Commonwealth developing and small states, participation in services value chains offers access to global markets that they could not otherwise achieve so quickly. This suggests that the services sector offers a potential alternative development route to manufacturing, enabling poorer economies to 'leap-frog' over manufacturing.

Developing countries' share in world services exports have indeed grown rapidly from 11 per cent in 1990 to nearly 30 per cent in 2010, with increasing sophistication helping a shift from the traditional transport and tourism sectors to information and communications technology (ICT) and other commercial services. Services will continue to be the

growth sector of the future. In value-added terms, services now account for nearly half of world trade. Services offshoring activities accounted in 2010 for US\$252 billion in total global export revenues and employed 4 million people globally. The United Nations Conference on Trade and Development (UNCTAD) 2012 World Investment Report shows services-sector foreign direct investment (FDI) at US\$570 billion in 2011.

Nevertheless, too few Commonwealth developing countries are taking advantage of the new opportunities to specialise in the export of services 'tasks'.

This paper considers in detail the various factors which drive competitiveness in services and the policy levers available to influence them. The paper concludes with a number of policy recommendations oriented to boosting the participation of Commonwealth developing and small countries in the services aspects of GVC activity.

### Recommendation 1

Inadequate donor activity, individually or jointly, exists to fix the information deficit on the services sector, on the services dimension of GVCs and on services trade opportunities for Commonwealth developing and small states. **Improving the evidence base and disseminating the results should be a prime focus of Commonwealth technical assistance and capacity building.**

## Recommendation 2

Commonwealth developing countries would benefit from greater opportunities to share and disseminate international experience regarding policy and regulatory settings that have proved conducive to attracting services work for the global market onshore. **Further background research should be conducted and case studies collected to inform an active policy and regulatory dialogue at Commonwealth level.**

## Recommendation 3

Many services are infrastructural in nature and local inefficiencies in their supply are prejudicing Commonwealth developing countries' opportunities to participate in global goods value chains. **Achieving efficiency gains in logistics services and transportation and otherwise facilitating two-way cross-border trade in goods should be a sustained focus of Commonwealth developing country policy attention.**

## Recommendation 4

There is global evidence that there are prerequisites for Commonwealth developing countries to enter global services value chains successfully and that these become more critical at higher points of value-added. One prerequisite is digital infrastructure and, in particular, cost-effective and reliable telecommunications links. Other prerequisites include technical interoperability, mutual recognition and global standards conformity and assurance. Investment in tertiary education and human capital is also vital. **Commonwealth technical assistance and capacity building efforts need to be expanded to cover services economy infrastructure.**

## Recommendation 5

In value-added terms, services account for nearly half of world trade and the upward trend is clear. Similarly, services dominate global investment flows. **Trade officials in Commonwealth countries should be encouraged to give much higher attention to trade and investment in services, including in inter-governmental negotiation at the bilateral, regional, megaregional, plurilateral and multilateral level.**

## Recommendation 6

Participating in global services value chains necessarily requires openness to services trade, including to imports of services intermediates. **Commonwealth developing countries should prepare for greater internal policy co-ordination on services trade matters and more intensive public-private policy dialogue and associated advocacy on global services value chains.**

## Recommendation 7

Commonwealth developing countries need assistance to devise appropriate strategies to promote exports of services into GVCs. **Commonwealth donor countries should partner with other trade-related international organisations to showcase best practice methods and tools for services export promotion.**

## Recommendation 8

Commonwealth developing countries need technical assistance to review their investment and innovation policy regimes. **Commonwealth capacity building efforts should focus on investment and industry policy in tandem with trade policy reform.**

### Recommendation 9

Services should be given higher priority generally in development co-operation initiatives. **Commonwealth capacity building efforts should be directed to**

**identifying and leveraging the factors that impact on competitiveness both at all-of-services level and in individual prospective services growth sectors.**

# 1. Introduction to global value chains: 'made in the world'

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The pattern of world trade has witnessed remarkable transformations in recent decades. As a result of the forces of globalisation and the revolution in ICT, goods and services trade can no longer simply be understood in terms of export or import of finished goods or services produced by one firm, at one location, in one country and thereafter delivered to an unrelated party in another country. Production of goods and increasingly of services now involves a combination of intermediate inputs and services activities, sourced globally, to make up a finished output for the final consumer market.

This 'fragmentation' of production into goods and services tasks has resulted in the creation of global supply or global value chains (GVCs).<sup>1</sup> A report from the World Economic Forum (2012) sees the emergence of GVCs as central to global economic convergence and integration and argues that GVCs 'have become the world economy's backbone and central nervous system.

The expression 'made in the world' was coined in 2011 by the World Trade Organization (WTO) and Institute of

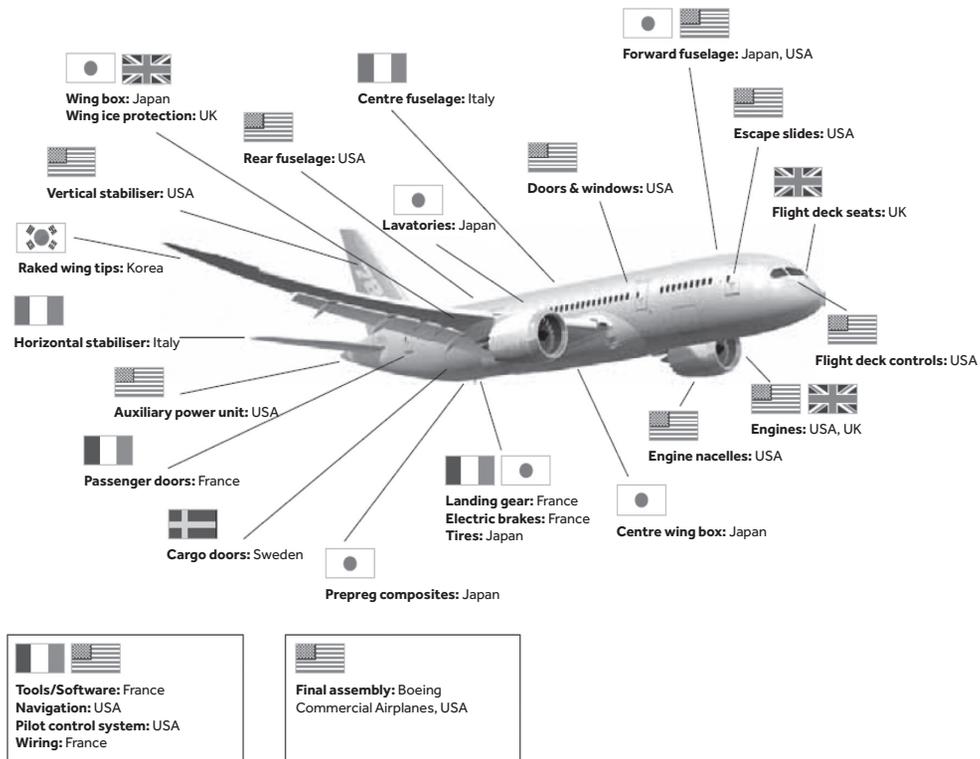
Developing Economies/Japan External Trade Organization (IDE/JETRO) in their groundbreaking collaborative work on 'trade in tasks', which focused on the operation of global goods value chains (WTO 2011). This cutting-edge study, in its bilateral breakdown of the production networks and intrafirm activity, has radically challenged the concepts behind traditional measurements of trade flows.

As the emblematic illustration of this study, the production chain associated with the Boeing Dreamliner (Figure 1), shows the study largely ignored the contribution of the services sector, focusing essentially on manufacturing components. The study not only neglected to highlight how services tasks contribute to the operation of global goods value chains, but also failed to identify how services activities themselves are now being fragmented into global services value chains. The release in January 2013 of new WTO/Organisation for Economic Co-operation and Development (OECD) data on trade in value-added ([www.oecd.org/trade/valueadded](http://www.oecd.org/trade/valueadded)), taking full account of services, was a critical component step in

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1. Some clarification is required of the concepts, generally used interchangeably in the literature, between global supply chain, global value chain and global production chain. This paper adopts the modern 'holistic' definitions set out in APEC Secretariat Policy Support Unit (2012). *Global supply chain* is the terminology given to a system of organisation of people, technology, activities, information and resources involved in moving a good or service from supplier to consumer. *Global value chain* (which for services often looks more like a network than a 'chain') refers to the full spectrum of value-added activities required to bring a good or service from its conception, through design, sourcing and intermediate inputs, production, marketing, distribution and support to final consumers. *Global production chain* tends to refer to the linkages within or among a group of firms or suppliers in a particular global value chain for producing specific outputs. All of these concepts apply also at the regional level.

Figure 1. The Boeing Dreamliner is 'made in the world'



Source: WTO and IDE/JETRO (2011)

filling this gap. The results are similarly radical, showing conclusively that services value-added makes up around half of global trade (and that is still without taking mode 3 into account).

Against the background of these conceptual and statistical breakthroughs, this paper is oriented to explaining the services dimension of GVCs and drawing out the implications for Commonwealth developing and small countries.

### 1.1 Drivers of GVC operation

Key drivers generally identified as contributing to the emergence of GVCs include lower transportation costs; improvements to information and communication technologies; technological innovations; and

more widespread availability of highly skilled workforces. An early contribution by Gereffi and Korzeniewicz (1994) distinguished between GVCs as either *producer-driven*, where large integrated industrial enterprises control the backward and forward linkages in a global production system (typical of capital-intensive industries such as those producing automobiles, computers, aircraft and electrical machinery), or *buyer-driven*, in which large retailers, brand-named merchandisers and trading companies set up decentralised production networks in a variety of exporting countries (typical of consumer-goods industries such as garments, footwear, toys, consumer electronics, household items and furniture).

The process of globalisation and evolution of global industries giving rise to GVCs is not a new phenomenon, but it has evolved through a number of complex different phases (Sturgeon 2011), giving rise to new conceptual and policy challenges. Each phase of evolution has impacted in different ways on Commonwealth developing and small countries.

Following the emergence in the 1960s of vertically integrated national firms and industries, the 1970s witnessed a wave of global dispersion of industrial activity through investment in offshoring by multinational corporations. The 1980s saw the first evidence of both geographic and organisational fragmentation of the firm through both outsourcing and offshoring into regional and global supply chains. The 1990s saw yet another evolution, with the rise of China and big new global suppliers. The 2000s saw the widespread application of digital technology, the beginning of services offshoring, global knowledge and innovation networks and the rise of India. Within this global context, there has been an evident nesting of related regional, and more local, supply chain corridors.

Over a period of 20 years or so, Commonwealth developing countries have participated increasingly actively in the resulting regional production networks in both goods and services, enjoying increasing levels of inward direct investment as they do so. Participating in such networks has proved an effective pathway to regional and global markets, although the benefits have not been even across or within the Commonwealth developing countries, with small and medium enterprises (SMEs) in particular still struggling to meet the relevant standards for access to these supply chains.

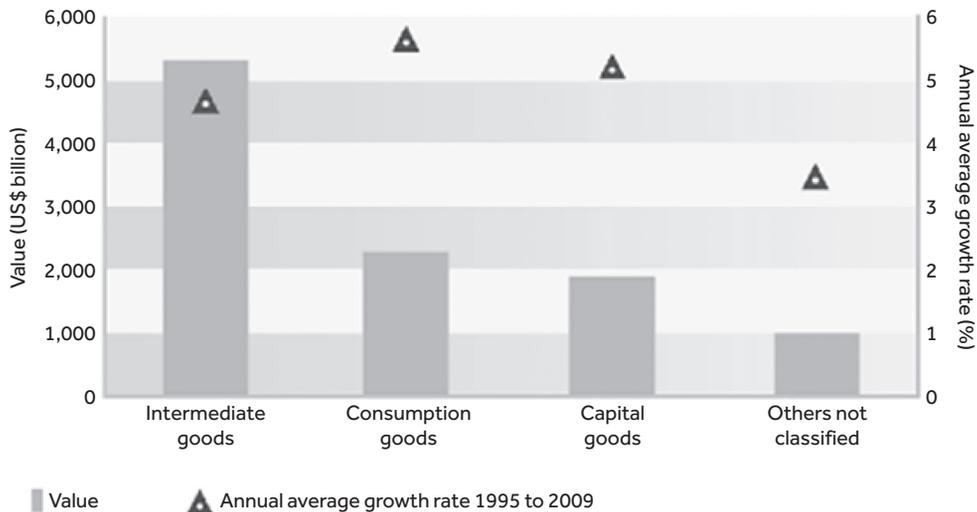
Lower tariffs, increased foreign direct investment (FDI), international outsourcing and the development of global supply chains have all redefined the economics and politics of trade and transformed trade patterns, and the international division of labour. A large and growing share of world trade is now conducted within, rather than between, international firms, which freely exploit competitive advantages by locating their operations in various parts of the world.

Global supply chains have also transformed the interests and activities of companies. Both multinationals and SMEs are not only interested in lowering trade barriers abroad in order to access export markets, they also benefit from lower barriers for imports of intermediate goods and inputs for processing. In other words, lower barriers for imports have become nearly as important as access to export markets in firms' quests to remain competitive.

## 1.2 Growth of trade in intermediates

Intermediate products now represent more than half of the goods imported by OECD economies and close to three-quarters of the imports of large developing economies, such as China and Brazil. Increased trade in intermediate inputs accounts for an expanded ratio of trade to world gross domestic product (GDP) (from 16 per cent in 1990 to 27 per cent in 2008). Figure 2 shows how significant intermediate trade in goods has become. This rising trade in intermediate goods is a direct reflection of the development of global production chains in the world economy (Sydor 2011). Trade in intermediates increasingly blurs the distinction between imports and exports and

Figure 2. The growing role of the intermediate goods trade



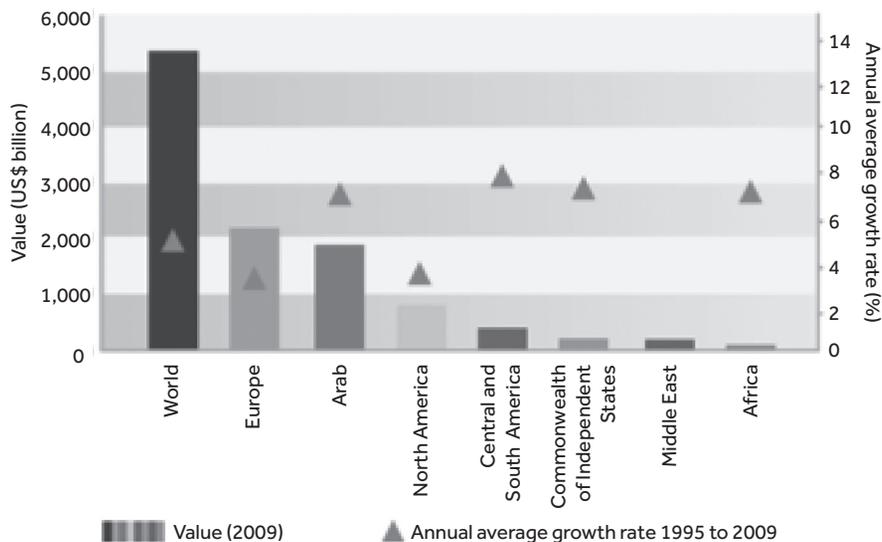
Source: Maurer (2012)

falsifies the designation of a product or service as produced in one location only. The old rules of origin are no longer easily applied, as rules of origin in preferential trade agreements are based on an antiquated understanding of where goods are ‘made’. But goods, and increasingly

services, are now ‘made’ everywhere, through GVCs.

As suggested by Figure 3, there does seem to be a regional dimension to intermediate trade, with the highest rates of growth in intermediates taking place in the more closely integrated regions. The

Figure 3. Growth of intermediate goods exports by region 1995–2009



Source: UN Comtrade Database and WTO estimates

growth of trade in intermediate goods explains the enormous share of GDP attributed to exports in a few *entrepôt* economies, such as Singapore and Hong Kong. Advanced countries, where very fine specialisation and product differentiation characterises much of the value added, and where exports are most intensive in innovation, are naturally drawn into trade of specific components and machines. The sectors that have registered large export growth, such as machinery, are also the sectors that have the highest imported intermediate input content in their exports.

All of this points to continuing and increasing interconnectedness between economies. As the role of trade in intermediates increases, bilateral trade balances and statistics traditionally measured are becoming less meaningful, as they fail to reflect value added (i.e. the value of exports minus imported inputs). As the WTO/OECD trade in value-added data (Escalaith 2013) clearly demonstrates, many countries' exports, including those of China, are economically less significant than they appear because they consist of imports that are subsequently re-exported and intermediates that are modestly reprocessed. In the case of an iPod Touch, for example, China adds only US\$4 to the value, but each one registers as a US\$150 entry into the USA/–China bilateral deficit (Gereffi 2011). Additionally, many developing countries export to many more trading partners than they realise, as these exports are often incorporated into final products and their contribution not recorded in trade statistics. A fuller discussion of this is found in Section 2.

Trade in intermediates means the cost of protectionism is higher, with particular dangers for smaller economies where intermediate imports are a larger proportion of exports. In addition, higher trade

barriers are more disruptive to intraregional trade, as countries tend to import intermediate inputs from within their own region. This partly reflects concerns over factors such as time constraints, trade and transportation costs, all of which are lessened by staying closer to home. European Union (EU) countries tend to import intermediates from other EU members, North American Free Trade Agreement (NAFTA) countries from other NAFTA partners and Japan, China, Korea and Indonesia from other countries in Asia (World Economic Forum 2012; Ali and Dadush 2011). All this highlights, and perhaps partly explains, the increasing weight placed on bilateral and regional trade agreements and in part the move away from a multilateral focus.

The rise in trade in intermediates also highlights the critical importance of trade facilitation in allowing a country's involvement in global production networks. While there is no simple correlation between the share of intermediate imports in a country's exports and the quality and efficiency of its logistics, several countries, such as Ireland and South Korea, that have high import content in their exports also have among the highest scores in the World Bank's Logistic Performance Index (2012).

### 1.3 Role of services in GVCs

There has been much attention in the trade policy conversation to global supply chains for goods. In this process, it has become better understood that for many elaborately transformed manufactures (such as the iPhone) the highest value added is contributed by services inputs, often at the research and development (R&D) and design phase, or at the logistics/distribution phase. All kinds of tasks along the various production

steps of the supply chain between these two high value-added ends are increasingly being outsourced and offshored to wherever each individual task can be most efficiently performed. This intermediate or intra-firm trade in services can be described as ‘trade in tasks’. The role of services in facilitating trade in tasks by providing the ‘glue’ at each point in the goods supply chain is increasingly recognised. So, also, is the fact that the ‘embodied’ services component of production and trade, especially of elaborately transformed manufactures, can account for a very high percentage, indeed over 50 per cent, of the total value of the good.

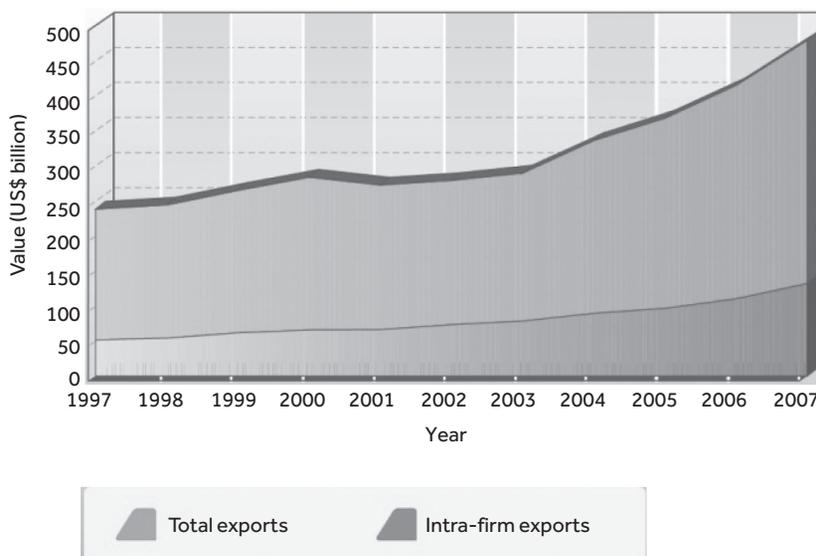
What remains much less well understood is the fact that value chains, including GVCs, exist not only in the goods sectors but also in the services sector itself. While Maurer and Tschang (2011) point out that the trend is less developed in the services area than it is for goods (Figure 4) globalisation is clearly bringing about a similar transformation in services as

in manufacturing. Services, especially IT-enabled services, are now being traded separately as tasks and making up their own value chain pathways to market. In new business models, services firms, like goods firms, are seeking to go up the value chain and to outsource non-core services functions. This leads to services becoming embodied not only in goods exports but also in final services exports.

Although similar in concept to goods value chains, services value chains may differ somewhat in the way they operate. In particular, they are less likely to look like linear chains: it might be more accurate to think of services as being ‘nested’ in wider services ‘networks’.

It is reform in telecommunications, together with the application of digital technology to a widening range of business services, that have been driving the rapid emergence of regional and global supply chains in services as well. Indeed, services intermediates, especially knowledge-intensive business services, are now the fastest growing component of world trade.

Figure 4. Intermediate services’ growing share of services exports: USA data



Source: Maurer and Tschang (2011)

Services GVCs are enabled by knowledge-intensive services industries where value can be 'captured' and 'stored' so that the production of these services can be separated from consumption and scaled up, creating higher added-value final services. Cross-border digital trade then enables the use of these services anywhere in the world, thus allowing for the development of services value chains in their own right.

In a services value chain, any activity or cluster of activities can either become a core competence or be outsourced from the parent firm. Many of these activities (for example, business back-office and data processing services) can also be offshored in locations abroad, leading to new competitive opportunities for specialisation and for the participation of emerging suppliers in these tasks. As in the case of goods, the objective of services firms is to engage in increasingly higher value-adding 'tasks', namely design, R&D and innovation, or logistics and marketing/brand development. This presents particular opportunities for Commonwealth developing countries and small states to develop competencies and undertake individual value-adding tasks.

The offshore services industry, which includes information technology outsourcing (ITO), knowledge process outsourcing (KPO) and business process outsourcing (BPO), has seen a dramatic increase in demand over the last two decades, most of which is coming from the USA, Canada, EU and some Asia-Pacific countries, particularly Japan. Firms from supplying countries tend to specialise in different parts of these services value chain processes. The amalgamation of all or some of these activities makes up the value of the final service product. Sturgeon (2011) notes that 'global integration is being driven by value chain fragmentation and better integration of the fragments'.

Although there has been little research to date on services value chains, it is clear that such chains are being created in a variety of ICT-enabled services sectors, including professional services, such as legal services and architecture, banking, tourism, education and health services, as well as computer and business processing services. The role that services play in GVCs for goods and in GVCs for services alone, is discussed more extensively in sections 4 and 5.

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## 2. Implications of the rise of GVCs for Commonwealth developing countries and small states

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GVCs have impacted not only on the structure of world trade but also on the destination of investment flows and on the process of economic development. The ability of countries to prosper

depends on their participation in the global economy, which today has become largely a story about how to foster their role in global supply chains (Gereffi and Lee 2012).

## 2.1 Development considerations

In a world of supply chains, developing economies, including the least developed, have increased opportunities to enter into intermediate activities by adding relatively small amounts of value-added to any particular product. GVCs therefore open up tremendous opportunities for development that did not exist before in the world economy. Rather than having to be proficient in all aspects of the production of a good or service, developing countries can now capture just one component or just one task. This changes the way that policy-makers can view comparative advantage, as it can be much more fragmented internationally than it was in the days of producing goods and services entirely at home. More than ever before, firms from developing economies have opportunities to enter the global economy.

Participation in international production chains in the services area offers great potential for developing and small states, and is potentially more viable than participation in GVCs in the goods area for a number of reasons. First, services are not linked to natural resource endowment. Firms do not need to make use of petroleum reserves or commodities when they are producing services. Second, for services, GVCs do not depend as much on the geographic location of the participating firms, as transport costs for services, especially when provided cross-border, are negligible. This means that distance should not be a major factor in terms of cost or offshoring decisions; however, proximity to markets can play a role in investor decisions in terms of time zones and how offshored services are used in

inputs to traded goods, where transport does play a big role. Likewise, land-lockedness and remoteness should no longer be the obstacles to trade that they once were.

One of the main development implications for developing economies of the new possibilities offered by services and GVCs is that it is possible for governments to 'create' a comparative advantage in a service task. Since services are all about people and human capital rather than physical capital, the role of policy can be determinant in this regard. Government programmes to train service providers, including, importantly, in the use of English as well as in ICT skills, and the role of education in shaping the quality of the workforce, can be highly critical for facilitating the ability of firms to enter GVCs.

Another development implication is that size is not a major factor either in the ability of a government to create a comparative advantage in a services task going into international markets. Because of the possibility of capturing only one type of services activity, even small economies may position themselves in niche markets. Also, services, unlike goods, are not subject to economies of scale in the same manner. Thus, producing a greater or smaller quantity of a service activity will have comparatively little effect upon final price compared to the labour productivity and the skill content and innovation going into it. For those countries on the lower income rankings, services may provide a platform for 'leap-frogging' stages of development if the government can help to create conditions necessary for developing the services sector, allowing countries to bypass the manufacturing stage and move directly into services, including in international markets.

Services exports are already contributing over 7 per cent of GDP for high-income countries, but still well below 5 per cent for middle-income countries. Importantly, as shown in Figure 5, services exports are making greater contributions to GDP for poorer countries than for middle-income economies: just below 6 per cent for lower middle-income economies and just over 6 per cent for low-income economies.

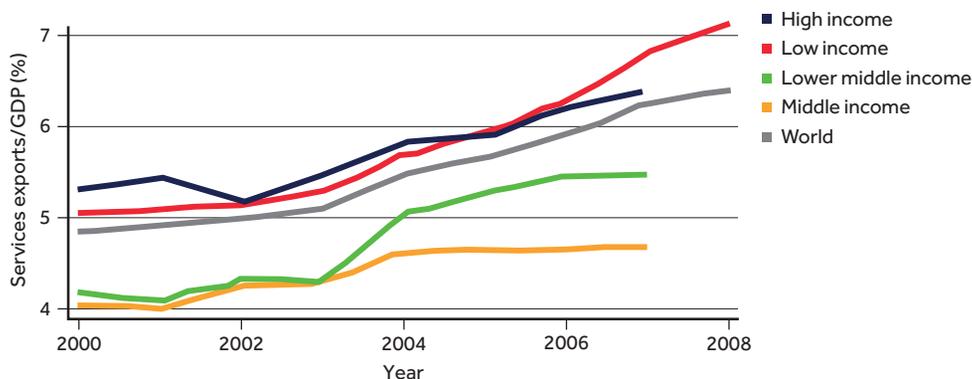
Of particular significance for Commonwealth developing and small states, this suggests that the services sector offers a viable alternative development route, as discussed previously, potentially enabling poorer economies to leap-frog over manufacturing. Finding a way to ‘fit’ into a GVC through taking on an outsourced services task is one of the ways that countries can target and achieve this objective.

The capture of a services task for a GVC may be conditioned upon the ability of a country to attract FDI, which is the driver of trade in the twenty-first century and a large factor behind the creation

of trade in intermediates and GVCs. Focusing upon attracting FDI in services offshoring tasks is of the utmost importance. It is through FDI that technology and innovation are often transmitted, particularly in small economies where the size of the domestic market is limited. This implies that government policy should be open and welcoming to foreign investment, especially in areas that underpin the efficiency of services performance. Policy incentives, used judiciously, can also be of importance here and help to shape desired outcomes.

The problem, of course, is that despite these opportunities, there is evidence that global market share may be declining for some Commonwealth developing countries. India of course is a star player. And within the African, Caribbean and Pacific group, for example, while South Africa stands out as a major player, and Kenya, Jamaica, The Bahamas, Mauritius, Nigeria, Ghana, United Republic of Tanzania, Barbados and Uganda all have services exports between US\$1 billion and US\$3 billion, the group

Figure 5. Services exports as a contributor to gross domestic product (GDP) at different levels of development



Source: Saez (2011) from World Bank, World Development Indicators

as a whole has lost market share from about 3 per cent in 1975 to 1.9 per cent in 2010 (Chambras 2012).

## 2.2 Poverty alleviation

Entry into GVCs can play an important role as a source of jobs and growth for Commonwealth small and developing states. However, the other positive spillovers they can generate are less well appreciated. For example, the opportunities that they open up for women which are broader than those they have traditionally played in developing economies. This is because much of the intermediates and ‘tasks’ are in the services sector where the majority of women are employed. Services activities do not require hard manual labour, nor risky and dangerous occupations. They can more easily be combined with part-time schedules as well, all of which facilitate the employment of women in the services sector. Contributing to tasks in GVCs is therefore an additional way to bring more women into the labour force, which has been shown to be a major factor in alleviating poverty and improving childhood educational opportunities (World Economic Forum 2012).

It is also important to differentiate between the ‘value chain’ *per se* and ‘capturing value in the chain’. For purposes of poverty alleviation, low value-added jobs are equally as important as high value-added jobs, especially for developing countries in their first experiences in capturing a services task, or if their level of human skills do not offer opportunities otherwise. Often low-value jobs are the first step toward gaining participation in GVCs. The Intel experience in Costa Rica is a case in point. Fifteen years

ago Intel created an assembly plant for microchips; now operations have evolved into R&D and are an important source of new designs. Intel’s presence led to the training of a new generation of engineers, providing engineering services both inside the country and as part of services offshoring, leading to positive spillover effects throughout the economy. As a result, an additional investor, Hewlett Packard, also entered the market and will hire as many engineers in cloud computing as can be trained. Multinational corporations (MNCs) have also been collaborating with Costa Rican universities to examine the curricula taught and to make sure they are relevant for future industry needs. This highlights how one small developing country has been able to participate in GVCs to advance its own development, beginning with insertion into a GVC at the lower end with the objective of job creation, poverty alleviation and skills training, and subsequently being able to move higher. Engineering and ITO services have been a big part of this success story (Gonzalez 2012).

On a cautionary note, domestic stakeholders often fear that participation in global activity could prove unsustainable and sometimes mean the future elimination of a services task or an intermediate input. GVCs do magnify and accelerate skills-biased technological change and firms/countries need to adapt. In a globalised context, firms can relocate services tasks very quickly to countries with lower costs, better skills and/or a more enabling trade environment. In this context, the challenge is to focus on appropriate education and skills training in order to create the appropriate competitive conditions to retain firms, but also to help retrain those who may be affected by job loss.

## 2.3 Participation in GVCs by Commonwealth developing and small economies

In the above section we discussed how neither size, nor resource endowment, nor geographic location, are major factors playing a role today in the ability of a country to create competitive advantage in a services area and thus to participate in a GVC through providing services tasks. These conclusions have implications for Commonwealth developing and small economies, offering up large areas of potential for future economic development. No longer should size be an overwhelming handicap in the realm of economic growth as it has been in the past. Importantly, Commonwealth developing and small economies should be able to shape their competitive advantages in services areas that correspond most to their priorities and local talent.

Many developing and small Commonwealth countries are already exporting services, some without being aware of it. For services, Commonwealth states enjoy a major advantage in their proficiency in English, which is the language of business. Many have already capitalised on this and begun to capture services tasks

through attracting offshoring investments, allowing them to take a foothold in GVCs. We present below some examples of Commonwealth states that have been able to attract offshoring investment and that have begun to develop areas of services exports that are feeding into GVCs. Many of these examples highlight the role that directed government policies and incentives have played in these outcomes.

It is difficult not to underscore too strongly the importance for Commonwealth developing and small states to participate more fully in global integrated production structures through a focus on services. Those countries that do not move in this direction will be left out of the most dynamic growth currents in world trade and investment. Additionally, emphasising services in the context of GVCs also means, as a corollary, better understanding of the role and importance of efficient services in stimulating economic growth and employment at the national level, as well as its role in both innovation, productivity and poverty alleviation. Section 3 allows us to better understand how to measure trade in services and how businesses actually trade services through GVCs.

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## 3. Understanding trade in services

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### 3.1 Growth of the services sector

The services sector now plays a critical role in both individual economies and the world trading environment, and that role is intensifying. Its importance has been

understated, and policy attention has been generally subordinated to the agricultural and manufacturing sectors and to trade in goods. In part, this is because measurement of the national services economy as well as the extent of services trade has been woefully inadequate. The reality is that

everywhere, the services sector is rapidly becoming the dominant economic sector, as illustrated by Figure 6.

In summary, the empirical evidence generated by the OECD, the World Bank and the academic fraternity, shows that:

- services are making a stronger contribution to overall economic growth than other sectors;
- services exceed 50 per cent, on average, of world GDP;
- services generate more than 60 per cent of jobs worldwide;
- services are making the strongest contribution to female employment and (to the extent that data are available) to male and female wages growth;
- services growth is strongly correlated with poverty reduction; and
- services R&D and services innovation are accounting for an increasingly dominant share of productivity growth.

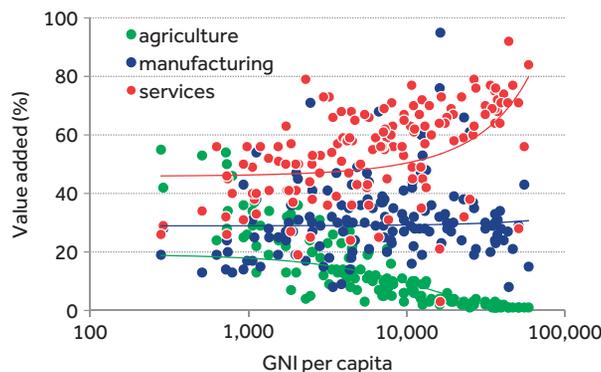
### 3.2 Defining and measuring services trade

The growing importance of services in world trade and the new global

distribution of activity through the offshoring of services tasks have implications for both how trade flows take place and their measurement. The way in which the contribution of services was previously measured, given the growth of GVCs, was clearly inadequate, with international trade statistics grossly understating the importance of services trade. Although cross-border trade in services was reported at 27 per cent of global exports measured by balance of payments (latest World Bank data), this is a significant underestimate due to inadequate measurement.

Traditionally, international merchandise trade statistics have been established from customs documents at the border, assigning the full gross value of an international transaction to the immediate economy of origin or the last producer in the value chain. However, this economy of origin is often only the last assembler in a long supply chain and will not have created nor benefited from the full value-added included in the final good. The value-added necessary to produce the product may be spread across several economies forming the value chain.

Figure 6. Sectoral composition of output and gross national income (GNI) per capita, 2007



Source: Miles et al. (2013)

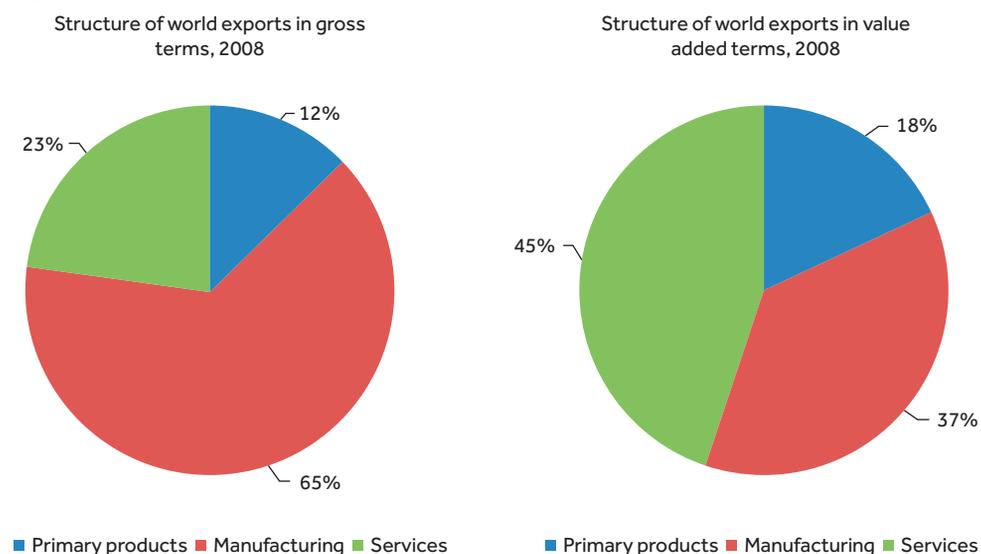
Some intermediate steps in a value chain will be constituted by goods components, but many will be constituted by services tasks. The services sector has been making a much larger contribution to exports than was recognised, because services are often integrated or bundled with goods and traded indirectly as intermediate inputs into merchandise production. The evidence has been mounting over the last few years that taking account of intermediate services inputs to goods trade might as much double the services share of global trade.

A database on trade in value-added, published as a joint effort by the WTO/OECD, finally allows for the importance of services in trade flows to be measured in a better way (OECD n.d.). This database on trade in intermediates, released in January 2013, records trade flows on the basis of value-added, or a country's contribution in value-added in either

goods or services, to a final product, through the use of an input–output table constructed for the world economy. The database covers 53 countries. Significantly, as illustrated in Figure 7, it confirms officially that the contribution of services to world trade is much higher than previously understood. With the services ‘embodied’ and ‘embedded’ in final products, including in GVCs, taken into account, the new database shows that services represent roughly half of the value of world trade (Escaith 2013).

Remarkably, we can now appreciate more fully the tremendous importance of services in world trade. This is still without taking the dominant component of international services trade into account, namely the value of mode 3 (commercial presence), which is given by the sales of foreign affiliates abroad. It will probably be a few more years before these flows are also captured adequately for many countries, though the existing

Figure 7. WTO/OECD data on world exports, 2008



Source: Escaith (2013)

statistical and anecdotal business evidence suggests that services trade generated by mode 3 is very substantial.<sup>2</sup> This is borne out by the fact that global investment flows have grown six times faster than global trade flows over the past 15 years and most of this growth has been in services. Three-fifths of the global stock of foreign direct investment is now in services. Taking services in its combined contribution to world trade (mode 1 on a value-added basis and mode 3) will clearly indicate in the future that services represent a far more important share of world trade than goods.

The advent of the new value-added database for trade is a welcome development and should help to highlight the importance not only of services but also of intermediate goods in general in trade flows, and thus of the operation of GVCs.

### 3.3 International business: how services firms trade

It is the investment decisions of MNCs, through their outsourcing and offshoring activities, that are driving the creation of GVCs worldwide. The operation of GVCs stems from the changed behaviour of firms and should be understood as part of the microeconomics of firm behaviour. At present there are changed incentives for goods firms within the world economy to ‘de-verticalise’ their structures, and to outsource a greater number of non-core functions, including services functions, which has fundamentally altered the nature of global competition. The main motivations of

the large firm in today’s world, for both goods and services producers, are to reduce transactions costs and lower risks, in a context of globalised output. Within these firms’ decisions, GVCs are not uniform: some are created by research-driven companies looking for high-research value-added, while others are driven by marketing-driven companies looking to source inputs in lower-cost locations.

Firms are drawn into GVCs through providing intermediate inputs, or tasks in the case of services. The usual pattern is for MNCs from developed economies to source from SMEs in developing countries. So while MNCs are the driver, smaller firms can tap into the opportunities created by this demand (Figure 8).

The trading environment is highly competitive and fluid. Innovation is the key to attracting and retaining business, along with the flexibility to adapt to rapidly changing demand. Delivering services is based primarily on skills and these skills need to be constantly updated. The globalised, highly competitive environment in which firms in GVCs operate mean that firms must be ever more vigilant to remain competitive, and be prepared to adapt and innovate as required.

Evidence is emerging that ‘total-factor productivity’, which used to be the unmeasurable residual once called ‘technological change’, is now becoming better understood as ‘services innovation’. Services innovation appears to contribute importantly to productivity growth and to services export performance. In many OECD countries, services firms are now the dominant contributors to R&D

2. See, for example, Drake-Brockman (2011a) which shows for Australia that balance of payments data probably account for only one-third of total services exports when mode 3 is taken into account.

Figure 8. Example of a services value chain



Source: IBM Corporation

(Tcha 2011). However, R&D is only one component, and a declining one, of total firm expenditure on innovation (which also includes design and business process restructuring, for example).

### 3.4 Exporting services by SMEs

Although their role is often underestimated, even in many industrialised economies, SMEs comprise 90 per cent of all businesses and employ 60 per cent of all workers. Often overlooked is the fact that SMEs are by far the most numerous participants in GVCs. For services, there are four times more SMEs participating in GVCs than larger firms. Also of significance is the fact that there are many more SMEs in the services sector than in manufacturing.

SMEs face different types of barriers than do larger firms (USITC 2010), including, primarily, access to trade

financing; identifying partners for GVC operations; and means of payment processing.

Unfortunately, as with services trade more generally, the available evidence on the international trading patterns and performance for SMEs is extremely scarce, and relies substantially on what is known about MNC experience and behaviour. It does seem that the size of the SME does not dictate its trade pattern, that there is a very high survival rate for those enterprises that do participate in international trade and that SMEs tend to trade more of their exports through indirect channels (OECD 2012).

Particularly for SMEs, being part of a network of other similar firms is critical for overcoming isolation, and appears to be more important than physical or cultural distance to a foreign market. In effect, access to large global enterprises located in capital cities provides avenues for SMEs

internationalisation. Considering the dynamics of SMEs in many services sectors, promoting clusters of related businesses and linkages to large multi-nationals may be the most trade-facilitating approach (OECD 2012: 5).

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## 4. The services trade dimension of GVCs

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### 4.1 Services as links in global goods chains

Services play an intrinsic and increasingly important role in the goods supply chain. Services inputs provide the 'link' or the glue at each point of the value chain, without which it could not happen (for example, transport, telecommunications, logistics, distribution, marketing, design and R&D).

The traditional goods chain both starts and ends with a series of pure services activities and embodied services are involved throughout the processing and manufacturing steps in the chain (such as product design or factory plant-controlling software). Embedded services are often supplied with the good (such as maintenance and repair, product insurance, leasing the product recall and waste services).

In modern economies which have high services proportions of GDP, merchandise suppliers cannot function without the intermediate services. Moreover, it is the application of enabling services such as telecommunications and ICT that have driven the segmentation of the supply chain into production units which can be dispersed geographically, and yet be connected.

The nomenclature varies slightly according to goods or services references: 'supply' and 'production' and 'chains'

and emphasise goods; 'supply chains' tend to look upstream from the buying firm. The idea of value chains covering goods and services resonates better with services stakeholders, even though the chain is more often a closed loop than linear.

Any value chain activity or cluster of activities (business function) can become a core competence or be outsourced, and most can also be offshored, leading to new competitive opportunities for specialisation at the country and firm level. Firms need to be able to be more flexible as they seek their core competence. The policy challenge is to give firms the space in which to be more flexible, to free up barriers to interoperability with other business functions in the value chain. The other challenge of course is to move up the value chain into higher value-added services.

### 4.2 Examples of embedded and embodied services value-added in the exports of goods

Services that are bundled with goods and that are therefore traded indirectly fall into two categories: embodied and embedded services. *Embodied* services are the services contained in products from the mining, agricultural and manufacturing sectors and inputted during the production process (e.g. energy,

transport, communications, insurance, accountancy, design, software and other technical expertise). They are delivered within the product. Other services can be *embedded* at the point of merchandise sale, for example, financing, training, maintenance, repair and other after-sales service. They are delivered alongside the product.

An ITS Global study (2010) suggested that, on the basis of International Monetary Fund forecasts of global GDP and trade volumes, total embodied services exports could increase to US\$47.2 billion by 2014–15. ITS Global points out that the outlook for embodied services exports will depend on any shifts in the intensity with which intermediate services are used to produce and deliver merchandise exports. Every percentage point increase in the intensity of intermediate services use in merchandise production is estimated to add over US\$1 billion to embodied services exports each year. The study notes the evidence that a convergence in production systems in manufacturing and services is underway, with the intensity of embodied services increasing. It observes that were the increase in the intensity of services use that occurred between 1998–99 and 2005–06 to be repeated over the period to 2014–15, embodied services exports would be approximately US\$53 billion a year in real terms by the end of the period.

Embodied services are an increasingly important component of value-added in regional and GVCs for many elaborately transformed manufactures. The role of services in facilitating trade in tasks by connecting the points in the goods supply chain is increasingly recognised. So also is the fact that the embodied services component of production and trade,

especially of elaborately transformed manufactures, can account for a very high percentage of the total value of the good.

The examples below illustrate products that contain numerous embodied and embedded services. We include them in order to underline the significant contribution of services to final manufactured output for a variety of products, before discussing services contribution to value chains in services alone.

#### 4.2.1 Services in the export of Australian coal

The 2010 ITS Global study, undertaken to measure the extent of embodied services in Australia's exports, shows that services are nearly twice as important to Australian export performance as exports of services recorded in the balance of payments suggests. Services are embodied in all merchandise exports, even the apparently least transformed, as Australian coal production demonstrates. ITS Global found that the output of the Australian manufacturing industry embodied on average 26.4 per cent of services and the output of the mining industry 31 per cent on average.

To extract A\$100-worth of coal in 2005–06, the Australian Bureau of Statistics input–output tables show that the average mining company spent A\$11.40 on wages and other labour costs, and A\$30.50 on intermediate inputs. Intermediate inputs are the goods and services that mining companies buy to enable its miners to extract coal with the company's plant and equipment. The average company spent A\$6.10 on goods: timber for construction, diesel fuel for its mobile plant, explosives, prefabricated buildings and new machinery. But it spent four times as much on services (A\$24.40): specialist mining expertise

such as geotechnical and mining engineering services, electricity to power the fixed plant and equipment, construction and maintenance of the plant, rail transport and property and business services such as legal services and accountancy. Over 80 per cent of the intermediate inputs used to extract coal were services. Intermediate services accounted for nearly one-quarter or 24.4 per cent of the final value of the coal produced in 2005–06.

#### 4.2.2 Services in the Porsche Cayenne and the Barbie doll

A recent study (Pasadilla 2007) suggested that for any global location, over 50 per cent of the average cost of manufacturing an automobile is embodied R&D, engineering and quality-assessment services. For one particular car, it was shown that, quite apart from the 17.5 per cent of value from high-tech components from Japan, 4 per cent for minor parts from Chinese Taipei and Singapore and 30 per cent for assembly in Korea, 7.5 per cent of value was added in Germany (design) and 2.5 per cent in Ireland or Barbados (data processing). While data are not available on the percentage value-added

breakdown involved, we know that the Barbie doll is likewise made in the world (Box 1).

There are many similar examples in the electronics industry. The original Texas Instruments telecommunications chip was conceived in Sweden, designed in France with software instruments developed in the USA, produced in Japan and the USA and tested in Chinese Taipei (Pasadilla 2007). More recent electronics examples are outlined below.

#### 4.2.3 Services in the iPod

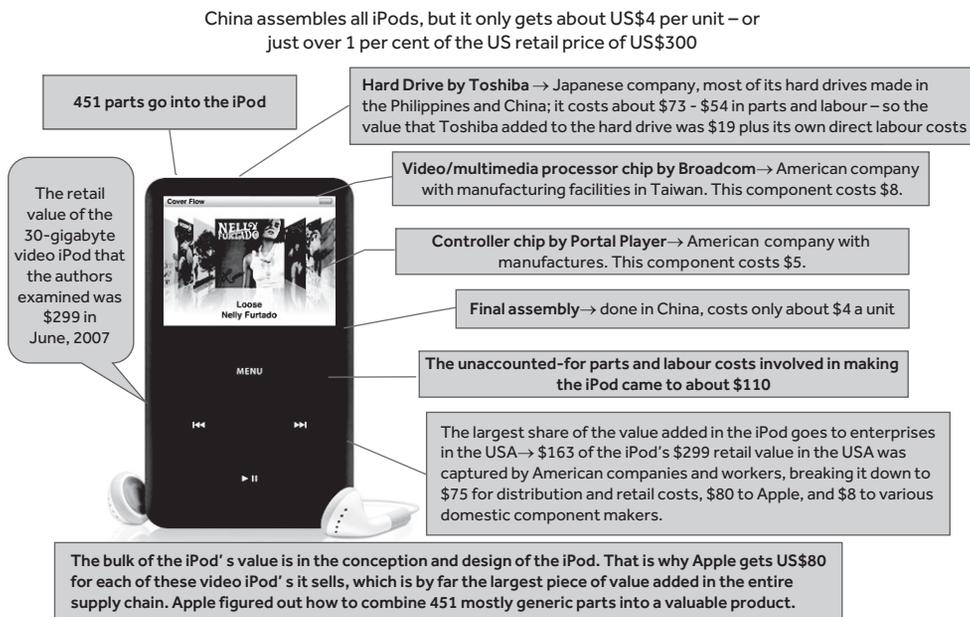
More than 50 per cent of the iPod's value has nothing to do with merchandise components and everything to do with the services activities involved in conception, design, retail and distribution. As shown in Figure 9, the iPhone is an even stronger example, where merchandise components represent less than one-third of the total value of the final product, suggesting that services account for two-thirds, although exactly how much value is added by each of the individual services components such as R&D, software development, engineering, marketing, transport, packaging and others is not clear.

#### Box 1. Barbie doll global value chain

- Design: California, USA
- Oil is refined into ethylene and formed into plastic pellets that are used to produce the doll's body: Taiwan
- Nylon hair: Japan
- Wardrobe cloth: China
- Clothes: Mexico
- Moulds for doll, paint pigments and cardboard for packaging: California
- Assembly: Indonesia and Malaysia
- Quality testing and marketing: California

Source: Pasadilla (2007)

Figure 9. iPod services chain



Source: Varian (2007)

#### 4.2.4 Services in the Nokia phone

A more detailed cost breakdown is available for the Nokia N95 phone. In this case, Figure 10 shows that merchandise components account for one-third of the total cost, value-added in Nokia's internal support functions represent another third and distribution and retail together account for one-sixth of total cost; the remaining sixth is licenses, final assembly and operating profit, with services therefore accounting for fully 50 per cent of the value of the Nokia phone.

Such simple examples demonstrate vividly not only that current trade statistics massively overstate the value in trade attributable to goods, and understate the size of trade in services, but that they also lead to massive distortions in overall bilateral trade balances.

#### 4.3 The shift to higher value-added

Services activities are clearly providing the linkages between the segments of production in GVCs and allowing them to operate. Services activities in core 'niches' serve to make cohesive both the producer-driven GVCs and the consumer-driven GVCs. Such activities that were once carried out solely within large corporations are being subcontracted and sourced out to autonomous firms, increasingly breaking down the production process into goods and services tasks.

##### 4.3.1 The 'smiley face' and services value-added

As Stanley Chih of Acer computers demonstrated in his famous 'smiley face' (Figure 11), the highest value-added

Figure 10. Embedded services in the Nokia N95



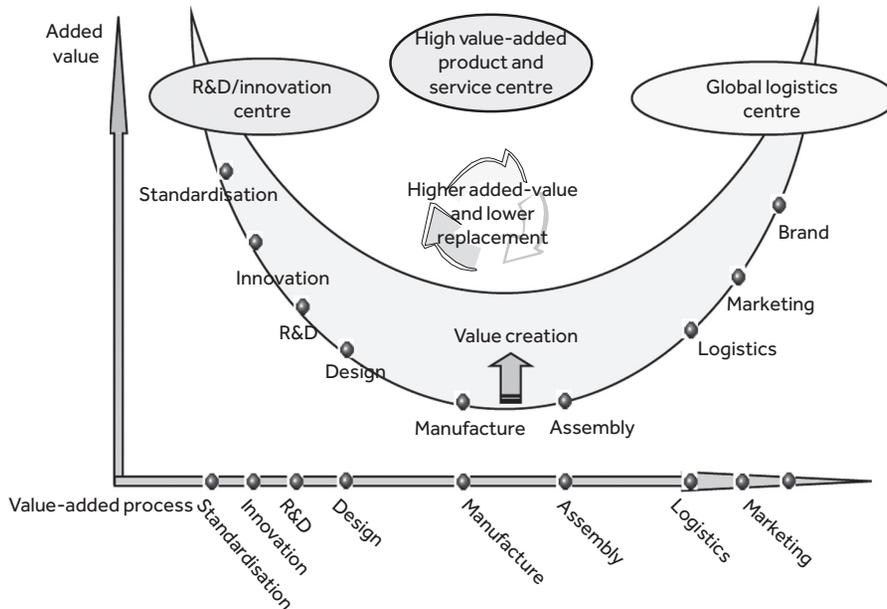
- Integrated circuits: 6%
- Camera: 3%
- Other parts: 11%
- Licences: 4%
- Value added in Nokia's internal support functions: 31%
- Nokia operating profit: 16%
- Final assembly: 2%
- Distribution: 4%
- Retailing: 11%

Source: Al-Yrkkö et al. (2011)

services activities, such as R&D/innovation or global logistics, increasingly dominate production value. While the original node of the production process is at the bottom

of the smiley face in the form of manufacture/assembly, the activities that add value to this core are located on either side of the value chain as they increasingly contribute

Figure 11. The 'smiley face': the role of services in value-added



Source: Bloomberg (2005)

in value to the final product, moving up to the R&D/innovation centre and the logistics centre, with all of the value added in between coming from services activities. To improve competitiveness, firms are seeking to move up the value chain on either side of the smiley face through moving into higher value-added services activities, and to focus on each firm's individual core competency while outsourcing all the rest. This process increasingly atomises international production and trade (Rabach and Kim 1994).

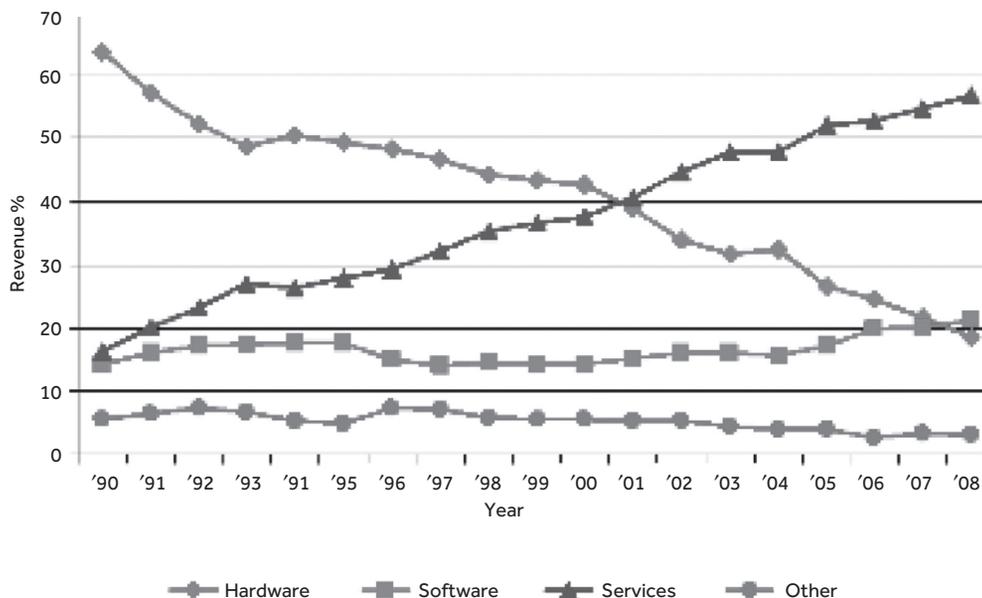
Studies of regional and global supply chains in goods have started to confirm the predictions of the smiley face, drawing attention to the fact that for many elaborately transformed manufactures (such as the iPhone) the highest value added is contributed by services inputs, often at the R&D and design phase, or at the logistics/distribution phase. All kinds of tasks along the intermediate phase of the smiley face between these two high

value-added ends are increasingly being outsourced and offshored to wherever each individual task can be most efficiently performed. This intermediate or intra-firm trade is *trade in tasks*.

IBM Corporation provides a dramatic example of corporate transformation from manufacturing to services, with the focus at the R&D/innovation end. The trend in profitability for IBM away from manufacturing and towards services was clear throughout the 1990s. By 2000, focus on hardware was no longer commercially appropriate, with software and services increasingly dominating the group's worldwide revenue. Corporate focus is now firmly at the 'ideation' end of the value chain (Figure 12).

The sourcing group Li & Fung illustrates the shift from manufacturing and services to more much complex global logistics. In the garment sector, for example, the group no longer merely brokers

Figure 12. IBM's business transformation to 'ideation'



Source: Koomen (2009)

### Box 2. Business transformation to 'orchestration'

Li & Fung produces more than 2 billion pieces of apparel, toys and other consumer items every year, accounting for more than US\$8 billion in garments and consumer goods for some of the best brands in the world. By the time of its 100th anniversary in 2006, Li & Fung had become the world's largest sourcing company, growing at a compound annual rate of 23 per cent for the last 14 years.

Yet Li & Fung does not own a single factory. It is a flat business for a flat world. The company started as a trading broker in Guangzhou (Canton, China) in 1906 during the Qing dynasty and transformed itself into a Hong Kong-based exporter and then into a multinational corporation. Finally, the company reinvented itself for the flat world in a new role, as a 'network orchestrator'. It is now the orchestrator of a network of more than 8,300 suppliers served by more than 70 sourcing offices in more than 40 countries and territories. The company indirectly provides employment for more than 2 million people in its network of suppliers, but only less than half a per cent of these are on Li & Fung's payroll. With this lean structure, each of the company's own employees generates about US\$1 million in sales, earning a return on equity of more than 38 per cent per year.

Source: Fung et al. (2007)

between a client and a producer, but orchestrates a sophisticated global network of suppliers of yarn, dyeing and weaving operations as well as cutting, making and trimming, for 'just-in-time' supply at the retail end (Box 2).

The above examples illustrate what appears to be a steady ongoing process of corporate transformation towards services and toward the international sourcing of services tasks through the operation of GVCs.

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## 5. The emergence of services supply chains

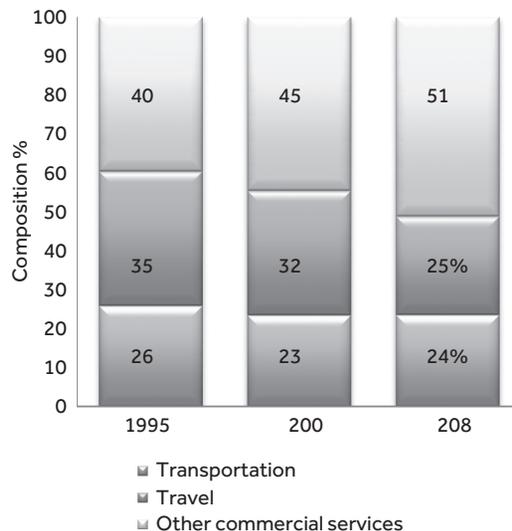
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Although a recent phenomenon, globalisation is bringing about a similar transformation in services as has taken place in manufacturing. In new business models, services firms, like goods firms, are seeking to go up the value chain and to outsource non-core services functions. This leads to services becoming embodied not only in goods exports but also in final services exports.

The development of services supply chains has resulted in the composition of services exports undergoing significant

change. 'Other commercial services' are becoming more important than the traditional 'travel' and 'transport' components of world services trade. The biggest contributors to the recent growth have been the knowledge-intensive business services, such as telecommunications, ICT services, R&D services, financial services, legal, accountancy and management consultancy services, architecture, engineering and other technical and professional services, advertising, market research, media and energy and environmental services.

Figure 13. Changing composition of world services trade



Source: Saez (2011)

Figure 13 shows that other commercial services are growing in relative importance, compared to the traditional services sectors of transportation and travel. Other commercial services include business services and ICT services, precisely those ICT-enabled services which have the potential to fragment into inputs into value chain operations.

Traditionally, services providers were constrained by their inability to capture, store and possess the value of the intangible. There were few opportunities to create step-by-step 'pathways' to market as services tend to be delivered and consumed simultaneously. The application of information technology is radically changing this; there is now a constant quest in the services sector to segment out any business function in which knowledge can be commoditised and packaged as a 'product', and where ownership can be established, production can be scaled up and trade can take place separately from production. This innovative

business process transformation is involving SMEs as well as creating globally integrated services firms.

It is the application of ICT, enabling the provision of an increasing range of 'smart' services that is transforming our societies and our economic performance. It enables the public and private sectors to address many of society's critical challenges in areas such as energy efficiency, improved healthcare, smarter transportation and better public services. ICT is central to the implementation of 'smart grid' and other smart or 'green' technologies. E-commerce, the advent and spread of low-cost broadband networks and the spread of advanced computer services, can help drive social and economic development. We have only seen the early beginnings of this shift to electronically delivered services. This will be the growth area of the future, offering productivity gain, high-wage employment, export performance and poverty reduction.

## 5.1 Outsourcing and offshoring of services: ITO, BPO and KPO

As individual firms focus on core competence to shift up the value-added ladder, a number of services activities are now being outsourced and sometimes offshored by both multinational corporations and even middle-sized firms. A simplified conceptual framework describing this process from a services perspective is presented in Figure 14. The horizontal line shows the supply chain, i.e. the simplified set of activities through which the service is delivered, or what we might call the 'pathway to market'. The vertical line shows the component industries that make up the total value-added component.

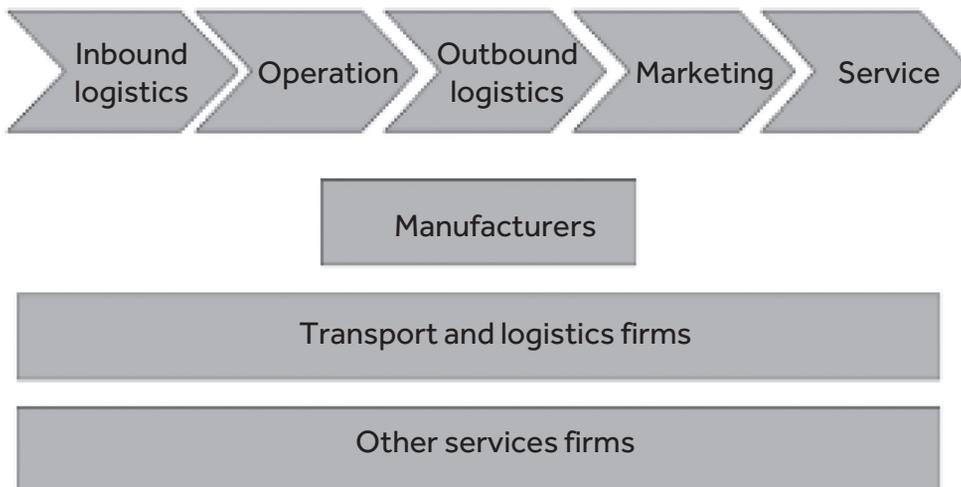
Gereffi (2011) has broken the horizontal line down further into a more granular set of activities, identifying eight separate business functions, generic across both goods and services sectors, all of which can be outsourced or offshored.

Researchers have started to map a number of specific services industry value chains. The offshore aspects of these chains encompass services activities conducted in one country, often as the result of foreign direct investment, often from a home-based multinational corporation, and consumed as business inputs in another. This can include a variety of business-to-business activities. At the Center on Globalization, Governance and Competitiveness at Duke University (Durham, NC, USA), Gereffi has set out a complex explanatory map encompassing these offshore activities, locating the separate business functions in terms of their value-added: the resulting offshore services value chain is set out in Figure 15 (Gereffi and Lee 2012).

The three main segments of services offshoring activities in Figure 15 are:

- information technology outsourcing (ITO);

Figure 14. Supply chain/value chain



Source: Nordas (2007)

### Box 3. Chain of generic business functions

1. **The primary activity of the organisation**, such as the production of final goods or services intended for the marketer for third parties for the purpose of generating income.
2. **Research and development of products, services or technology**, including designing, redesigning, or improving products or services, equipment or procedures, or basic research and experimentation with new technology, systems and processes.
3. **Sales and marketing**, including presale interactions with existing or potential buyers, advertising, market research, account management, managing brands or products.
4. **Transportation, logistics, and distribution**, including packing, storing, shipping or transporting in-process and finished products, or warehousing inventory.
5. **Customer and aftersales service**, including call centre services, maintaining and repairing products, technical support, customer service and warranty support.
6. **Management, administration and back office functions**, including top managers, middle management, administrative support, procurement, human resources, accounting, billing, legal and finance.
7. **Information technology systems**, including developing, maintaining or repairing computer systems for internal use, writing software for internal use and processing or managing data for internal use.
8. **Facilities maintenance and repair**, including maintenance and repair of owned or leased space or buildings, or janitorial and cleaning services.

Source: Gereffi (2011)

- business process outsourcing (BPO); and
- knowledge process outsourcing (KPO).

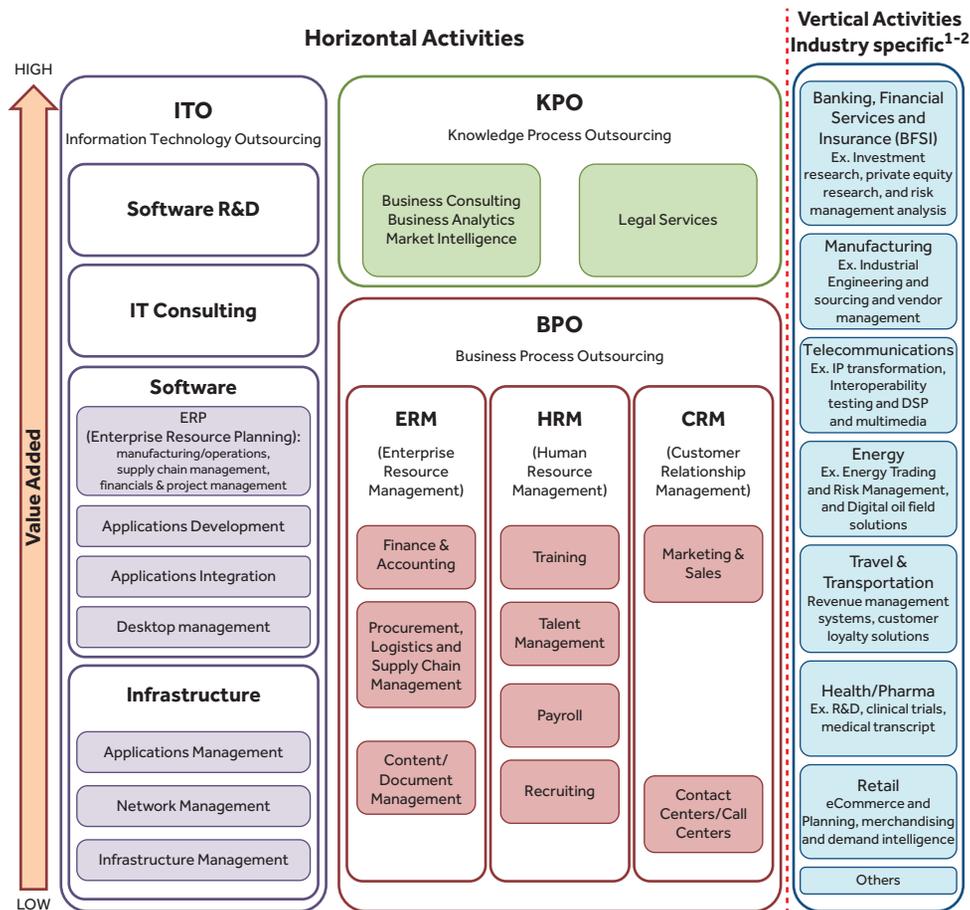
The ITO segment has four categories: software, R&D, ICT consulting and infrastructure. The BPO segment contains three main categories, including enterprise resource management (ERM), human resource management (HRM), and customer relationship management (CRM). The KPO segment includes business consulting, business analytics, market intelligence and legal services. Each of the various activities or services tasks shown under the ITO, BPO and KPO value chains is representative of a different level of value-added. For example, software R&D adds more value than network management in the ITO value chain. Likewise, finance and accounting add more value than document management in the BPO services value chain.

And business consulting adds more value than market intelligence in the KPO services value chain. The competitive challenge for firms is of course to move up the value chain or to cover a larger number of related activities in the services value chain.

The offshore value chain is further subdivided into services that can be provided across all industries (horizontal services) and services that are industry specific (verticals). Firms operating in the horizontal vector are process experts, while those operating in vertical chains have industry expertise and their services may have limited applicability in other industries.

Within the horizontal vector, activities are related to supporting generic business functions such as network management, application integration, payroll, call centres, accounting and human resources. In addition, they include higher value services such as market

Figure 15. The offshore services value chain



Source: Gereffi and Fernández-Stark (2010: 5)

intelligence, business analytics and legal services. Within the horizontal services value chain, ITO make up the low, middle and high segments of the offshore services value chain, BPO activities are found in the low and middle segments, while KPO activities are the highest segment of the chain. The value of each activity is correlated with its human capital content (education level), that is, lower value-added services require fewer years of formal education.

This categorisation provides an initial blueprint for economic upgrading

strategies within the industry, as firms attempt to climb the value chain for offshore services. The substantial growth of the offshore services industry presents a challenge when it comes to collecting data for the relevant services. According to OECD (Backer and Miroudot 2012) estimates, the size of the offshore services market would have been approximately US\$252 billion in 2010. The highest compound annual growth rate has been experienced in the KPO segment (58 per cent), with ITO (26 per cent) and BPO (25 per cent) following.

## 5.2 Examples of services-only GVCs

Research on pure services value chains is only in the early stages and there are not yet many examples of close mapping of this relatively new but growing phenomenon. We provide examples below for tourism and banking.

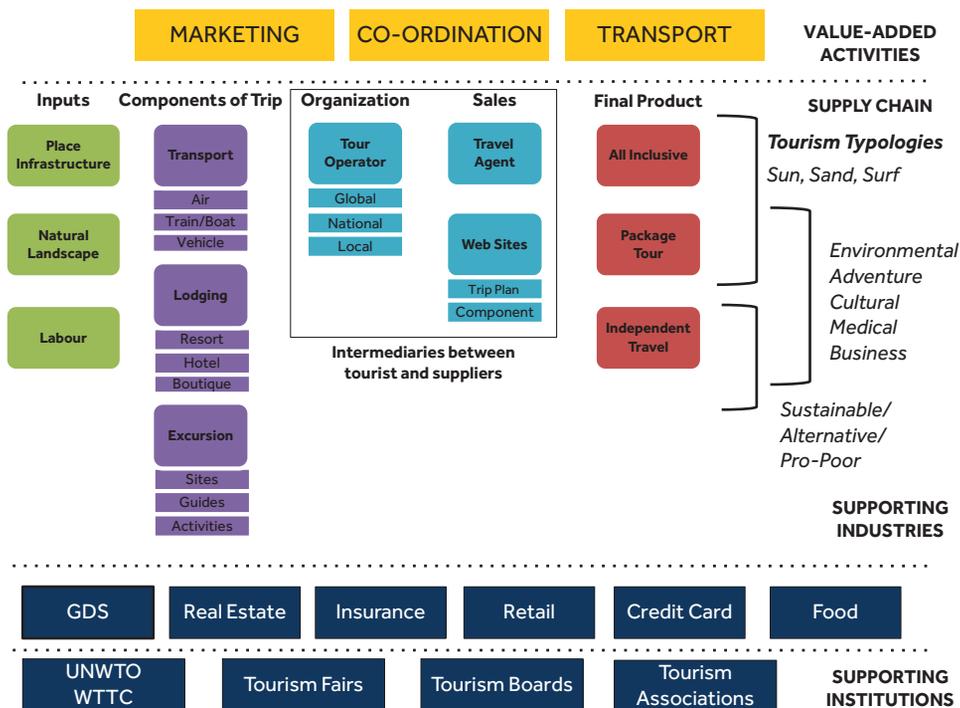
### 5.2.1 Tourism GVC

The tourism global production network can be characterised, as in Figure 16, as having five segments: inputs, components of trip, organisation, sales and final tourism product. The components of trip, organisation and sales segments are represented by tourism businesses in inbound and outbound tourism destinations. The

trip segment components consist of travel, lodging and excursions. Every segment is a mix of large and small firms and includes the potential, if the investment regime allows it, for a degree of FDI.

The organisation and sales segments act as intermediaries. Within the organisation segment, tour operators knit together an array of tourism products to create the tourist experience. In the sales segment, travel agents are the strongest retail venue. They sell tourism products, online and in sales offices, and inform potential tourists about destinations and suppliers. These tourism intermediaries are often vertically integrated operations, including not only retail sales and tour operator co-ordination, but also hotels and air transport. All the tourist experiences can be bundled together and sold as a packaged tourism

Figure 16. Tourism global production network



Source: Christian (2012: 3)

product by global tour operators. Travel agents can operate as subcontractors to global tour operators, but can also sell their tours directly to tourists.

The tourism GVC (Figure 17) follows the tourist's 'footprint', or the series of their interactions with firms, and includes the distribution, transport, lodging and excursion segments. One of the goals of countries or firms who are part of the tourism value chain is to upgrade their activities along the chain. Four upgrading trajectories are key drivers of the global tourism industry:

- pursuing pro-FDI policies to attract international hotels offering higher levels of luxury;
- upgrading the co-ordination and destination trip planning by global tour operators;
- using ICT upgraded services to establish more sophisticated web presence; and

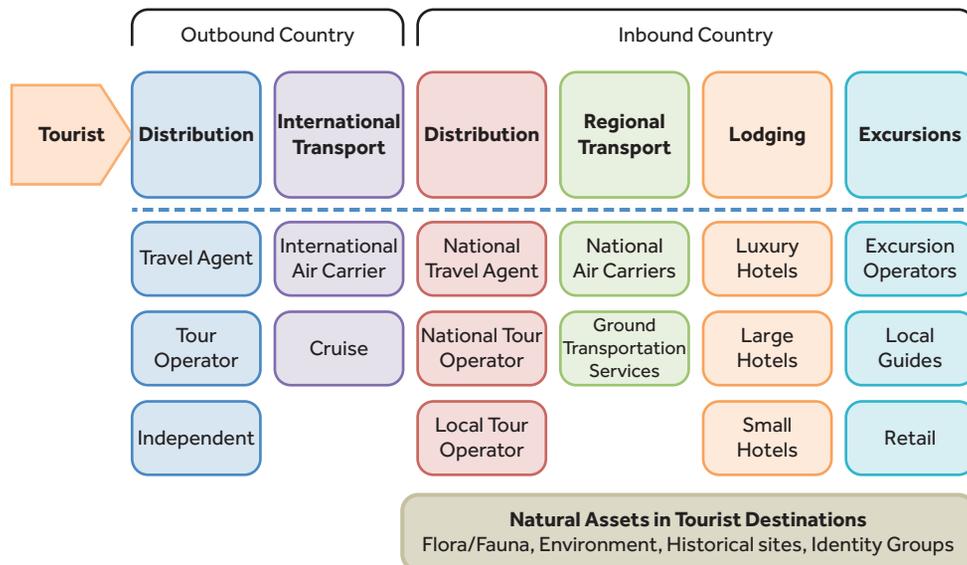
- catering to the growing diversity of international tourists with varied tastes and preferences with ever greater specialised products.

All these drivers present new challenges for developing countries, especially those dependent on tourism receipts for foreign exchange.

### 5.2.2 Banking and financial services GVC

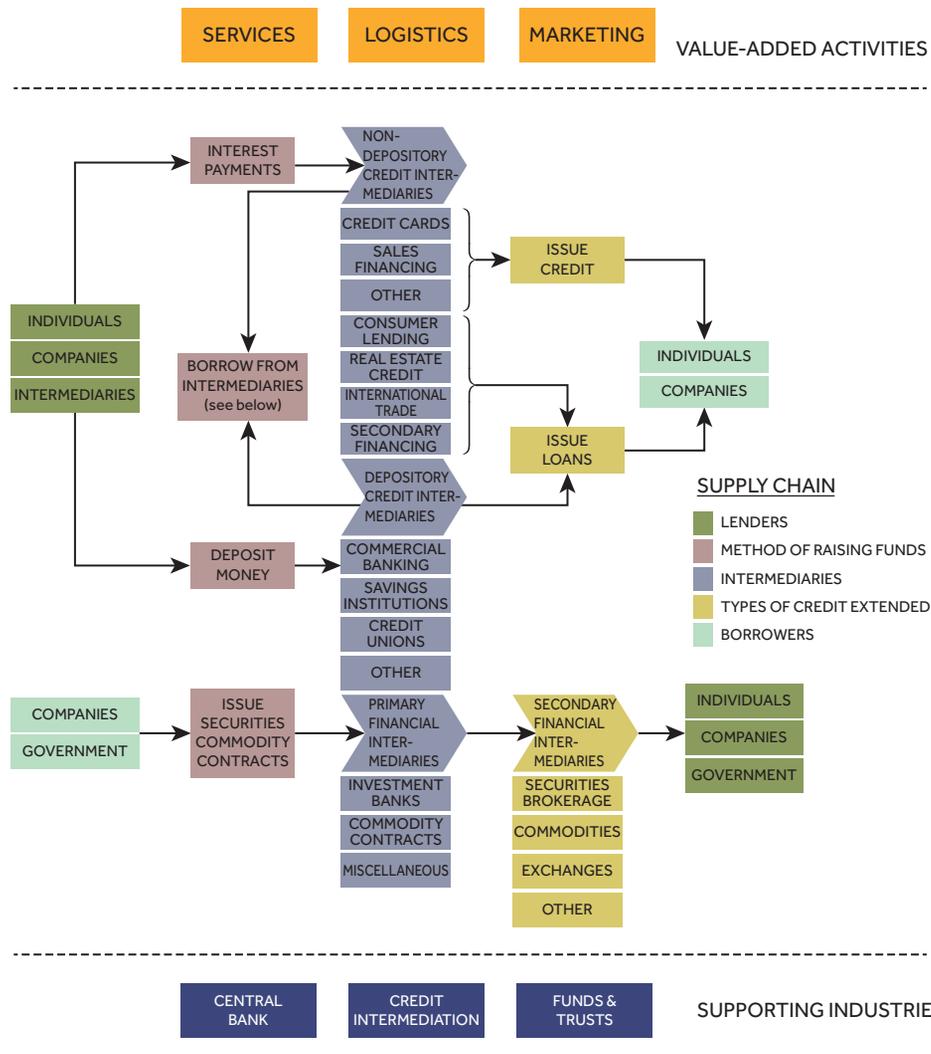
While banking and financial services are key intermediary inputs or embedded services in nearly all manufactured outputs in some form or another, banking and financial services activities can be fragmented into a value chain on their own. A banking and finance value chain is based entirely around the production of services. In this industry, the 'raw materials' are lenders and borrowers (individuals and corporations) that

Figure 17. Tourism global value chain



Source: Christian et al. (2011: 11)

Figure 18. Banking and financial services value chain



Source: Referenced in Drake-Brockman and Stephenson (2012)

appear at both the beginning and end of the chain.

As shown in Figure 18, the financial ‘products’ provided by this services value chain are divided between credit intermediaries (both depository and non-depository) and financial intermediaries. These institutions primarily collect funds through deposits and lend funds by

issuing loans, but the fine line between the functions of commercial banks and investment banks is continually becoming thinner, and in many cases commercial banks also conduct investment banking. Moreover, the banking transaction does not represent the end of the relationship between the lender and the borrower. Banking services, like other

services, generally entail the establishment of a relationship between the two and as a result, firms perform a variety of activities before and after the sale of a product.

These preliminary initial examples of GVCs in tourism and in banking are provided to demonstrate the business insights that can be generated by services industry value chain mapping, a discipline in its

infancy in most Commonwealth developing countries. Value chain maps help businesses and governments to understand better where local enterprises are located in the broader value chain. This is a first analytical step in the process of identifying the means by which to climb the value-added ladder on either side of the relevant industry smiley face.

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## 6. Participation in services exports and GVCs by Commonwealth developing and small states

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### 6.1 Services are being exported, including into GVCs

Commonwealth developing and small states are already active exporters of services, some of which are destined for use in GVCs. India's success is well known: exports of software and business process services contributed to about 33 per cent of India's exports in 2007–08 (Goswami et al. 2012: 25). Less well known is that most other Commonwealth developing countries are also successfully exporting services, both within their own regions and to high-income countries. South Africa is a global player in financial and professional services. Tourism, including health tourism, is the life blood of the Caribbean.

It is difficult to trace these exports due to the lack of detailed data on these intermediate inputs in trade statistics. Although the new OECD-WTO database on trade in value-added is now available, it covers only a limited number of countries and most of the

Commonwealth countries are not included. Therefore, it is still the reality that the only way to obtain information on services being exported for most Commonwealth developing and small states is through case studies of individual countries and sectors. The examples below have been extracted from various such case studies conducted mainly by international organisations such as the World Bank and the United Nations Conference on Trade and Development (UNCTAD). The studies cited illustrate the wide variety of services that are being exported by Commonwealth countries, ranging from medical tourism to education, professional services, and the better known information technology services.

It is worth noting that the World Bank study on developing country services exports (Goswami et al. 2012) draws attention to the fact that a number of Commonwealth developing countries have revealed comparative advantage not only in labour-intensive services,

**Table 1. Revealed comparative advantage in services exports for developing countries: a few examples**

Services sector	Input intensity	RCA for LDC group	Developing countries with RCA >1 (examples)
Communications services	Skill and technology intensive	1.29	Indonesia, Venezuela, Colombia, Zambia, Philippines, Botswana, Egypt, Argentina, India
Computer and information services	Skill and technology intensive	2.08	India, Israel, Costa Rica, Sri Lanka, Uruguay, Armenia, Argentina
Construction services	Labour intensive	1.32	Russian Federation, Egypt, Malaysia, Senegal, Mozambique, Tunisia, Indonesia, Slovenia, Israel, Turkey, Botswana
Financial services	Skill and technology intensive	1.30	Tajikistan, India
Insurance services	Skill and technology intensive	0.33	Bahrain, Mexico, Peru, Bolivia, Botswana, Zambia, Paraguay, Sri Lanka, Armenia, Chile, Brazil, Turkey
Other business services	Skill and technology intensive	0.72	Lebanon, Brazil, Paraguay, China, Oman, Israel, Argentina, Philippines, Russian Federation, Botswana, India
Transportation	Labour and resource intensive	1.84	Chile, Ethiopia, Azerbaijan, Sri Lanka, Kenya, Egypt, Uruguay, Colombia, Iraq, Tunisia, Pakistan, China, Malaysia
Travel	Labour and resource intensive	1.69	Mexico, Turkey, South Africa, Costa Rica, Tunisia, Philippines, Malaysia, Egypt, Colombia, Indonesia, Argentina

such as construction, travel and transport, but also in skill- and technology-intensive services, such as communications services, ICT services and financial services. Table 1 shows the index of revealed comparative advantage (RCA). When the RCA index is higher than 1, it means that the relevant product group has a higher share in the country's exports than its share in world exports. The World Bank study suggests that common language, colonial history and legal systems have been important contributors to these various success stories.

### 6.1.1 Medical tourism: India and Malaysia

Medical tourism involves patients going to another country for urgent or elective medical procedures, including rehabilitation and recuperation. The main services providers are private hospitals and clinics. When combined with a stay in a foreign location, often with tourism destinations, the activity has been labelled 'medical tourism'.

Such tourism demand is rising, with the growth of the middle class in developing economies and the ageing populations in

OECD countries. The global market for 'spa wellness' and medical tourism combined was variously estimated in 2005 at US\$40 billion (ITC 2014) and expected to have grown to US\$100 billion in 2012. Greater awareness of alternative medicines and natural healing is driving demand for spa wellness, while longer hospital waiting times and increasing domestic costs for ageing populations are driving associated silver/retirement services (Goswami et al. 2012). Developing countries are offering advantages of cost, speed, quality of service and attractive locations for the delivery of these services.

### *India*

India was one of the first countries in Asia to recognise the export potential of medical tourism and the advantages of positioning itself to claim a significant share of this market. The Indian government has heavily supported the development of the sector through marketing initiatives, visa facilitation, the promotion of centres of excellence, hospital accreditation systems and effective public-private partnerships. In addition, airport infrastructure has been improved to ensure ease of access both in and out of India.

As a result, the number of patients travelling to India for treatment is estimated to grow to nearly half a million annually by 2015. That figure increased by nearly 30 per cent between 2009 and 2011. India's main markets for medical tourists have been industrialised countries, particularly the UK and USA. Some patients come from neighbouring South Asian countries, such as Bangladesh and Pakistan, and China is also a growing market.

The main attractions of the sector are the relatively low cost of procedures, the number of physicians trained in the USA,

and state-of-the-art technology following the entry of a number of private players into the industry. The services offered range from medical procedures, dental services, alternative 'wellness' facilities and treatments, and a cord blood bank. The development of the sector has required acknowledgement and addressing of a variety of issues including perceptions of poor sanitary practices and hygiene, equity issues between treatment of wealthy foreigners compared with non-availability of services for domestic consumption, and "brain drain" from rural areas.

### *Malaysia*

Health tourism in Malaysia has been largely private-sector driven, co-ordinated by the Association of Private Hospitals of Malaysia. Foreign investment has been strong: private hospital numbers grew by 350 per cent between 1980 and 2005 and links to global health supply chains deepened, with new systems of referrals and cross-referrals between regionally and internationally linked hospitals and clinics. The regulatory environment has been supportive. The government has recognised 35 private hospitals as facilities for health tourism and provides associated fast-track clearance for patient visas.

ITC (2014) reports that 300,000 medical tourists visited Malaysia in 2006. By 2011 that number had nearly doubled, to 583,000. Nearly half (49 per cent) of the hospitals offering services are in Penang, and 35 per cent in the Klang Valley (including Kuala Lumpur and Selangor).

Malaysian hospitals offer Western medicine and a variety of alternative medicines. As a Muslim country, Malaysia benefits from an association with Middle East markets (as does Bangladesh). In

2008, 11,000 medical tourists came from the Middle East. Patients also come from neighbouring countries, such as Indonesia, attracted by the services available, short travel distances, reasonable costs and cultural considerations. Those from Singapore were attracted by low costs and the fact that they are able to use their health insurance in Malaysia.

Forward-looking government policy has played a role in the development of this sector. Early to recognise the potential for medical tourism, the Malaysian government took steps to actively develop the sector. In 1998, the government established the National Committee for the Promotion of Health Tourism, comprising airlines, hospitals, travel and tourism agencies and the Malaysian Industrial Development Authority. The committee was asked to look at marketing and promotion, tax incentives, fee packaging and accreditation for the industry.

In 2009, the government set up the Malaysia Healthcare Travel Council to drive the initiative. The council works closely with hospitals and has established a dedicated call centre, offices in other countries and a dedicated lounge at the international airport for medical tourists. In addition, the government relaxed and speeded up visa restrictions and removed restrictions on licensing foreign specialists. These policy measures have paid off. The sector is expected to grow at a rate of 21 per cent between 2011 and 2014. Malaysia offers cost-effective treatment, upgraded hospital facilities that equal or exceed Western standards and trained skilled professionals.

### 6.1.2 Education services: Ghana

Ghana's traditional exports are usually described as including cocoa, gold and

timber. However, Ghana has also concentrated recent efforts in the development of exports in the educational sector. Ghana is exporting educational services in the form of admissions of foreign students into Ghanaian colleges and universities. Most foreign students who study in Ghana are from the francophone west African countries. Nigerians students who want to benefit from the quality of the Ghanaian educational system are also availing themselves of the new opportunities offered. Factors reported as making Ghanaian educational institutions attractive for foreign students include the political stability of the country, the friendliness and hospitality of its people, good road infrastructure in the main cities, improving utility coverage in terms of telecommunications, water and power and comparatively good housing and hostels for students. As a result of the promotion of these services, Ghana has become the leading destination for learning English for francophone countries in west Africa.

### 6.1.3 Professional services: Kenya

Kenya, the country with the most advanced human resource base in the East African Community (EAC) region, has taken the opportunity to diversify its exports by development of its services trade profile. Over the past few years Kenya has targeted export of professional services to other EAC states, riding on increased demand for these services in a region of 127 million people and a combined GDP of US\$73 billion. A survey undertaken by the World Bank and Kenya's Export Promotion Council found that demand for professional services such as banking, insurance, legal services, accounting, architecture,

ICT and engineering has been rising in response to the trained professionals available in Kenya (Dihel et al. 2012). As shown in Table 2, many of these professional services are exported to other countries in the east African region. However, the World Bank study suggests that more than half of Kenyan exporters, particularly those operating in the insurance, BPO, non-banking financial, ICT and freight-forwarding services sectors, have business-to-business, i.e. GVC clients in multinational and other private enterprises.

Official data that would allow for a proper evaluation of the importance in value of the exports of these professional services are not available. The services share of Kenya's exports has been stable at around 3 per cent; however, nearly all of this (90 per cent) is measured as travel and transportation services.

The World Bank case study on Kenya was carried out through a survey of 52 professional services firms (Dihel et al. 2012). Key survey findings include:

- The majority of service exporting firms are 100 per cent Kenyan owned.

- The subsectors with greatest export volumes are insurance, accounting, non-banking financial services and BPO services.
- Most Kenyan exporters send their services exports through cross-border (mode 1) trade.
- About 44 per cent of Kenyan exporters use FDI (mode 3) to deliver services abroad. Firms in the BPO, ICT and information technology-enabled services (ITe) sectors often set up sales subsidiary offices in foreign markets.
- Mode 4 is also used regularly by Kenyan firms for the export of services, especially in the architectural and engineering sector, for projects in other east African countries.
- Kenyan firms export services to numerous markets in as many as 40 different countries, although the regional markets of the EAC tend to dominate the export flows.
- Kenyan professional firms have clients in many countries, with about a quarter in EU countries.
- Developed countries using Kenyan services into GVCs (the UK and USA)

**Table 2. Export destinations by services sector in Kenya**

Services subsector	Typical export destination
Accounting	East African Community (EAC)
Architecture	EAC
Business process outsourcing	USA and UK
Engineering	EAC
Logistics	Global
Information and communications technology	EAC, USA, Europe
Insurance	EAC
Legal	EAC
Financial	Global

**Source:** Reproduced from Dihel et al. (2012: 250)

are the most important markets for Kenyan exporters in the BPO sector. However, regional markets in east Africa are the most important destinations for exports of accounting, architectural, engineering, insurance and legal services.

The World Bank case study underlines the advantage of Kenyan firms as ‘value services’ providers for BPO exports, able to provide quality services at a lower cost than local providers. At the regional level, Kenyan firms are identified as ‘premium-quality’ services providers, especially in neighbouring countries lacking skilled professionals.

Constraints cited for the ability of Kenyan firms to expand their services abroad include obtaining intelligence on foreign markets and the lack of an export business plan. Additionally, firms face a series of regulatory barriers that affect their operations and their export opportunities (tax-related restrictions, excessive procedures and licensing requirements) as well as skills mismatches and skill shortages. The lack of a positive branding for Kenya’s exports is also cited as a dampening factor.

It does not seem that the government of Kenya has implemented any directed policies to encourage the development of services and services offshore activities. In this context Dihel et al. (2012) suggest that there is a large potential for the development of further opportunities in exporting BPO and other professional services.

#### **6.1.4 ICT and ITeS services: Bangladesh, India, Malaysia, Uganda and South Africa**

Many Commonwealth developing and small countries are focusing on attracting investment in the ITO area, and many have done so successfully, as the examples below illustrate. Unfortunately, available information is still scarce, and there is a great need for more knowledge through case studies.

##### *Bangladesh*

The ICT and ITeS sectors in Bangladesh have been targeted by policy-makers for the development of ICT and ITeS exports. There is a large pool of trained engineers and operators in the country, which makes for an attractive sourcing base, together with its English language and low-cost labour. Despite the advantages, the sector has been slow to take off in terms of generating offshoring exports, in part because of the difficulty that firms face in identifying suitable business partners abroad and inadequate national branding efforts resulting in low visibility of Bangladesh as an offshoring location on the international marketplace. These deficiencies are in the process of being addressed, including through an International Trade Centre project, promoting Bangladesh as a global ITO-sourcing location in co-operation with the Bangladesh Association of Software and Information Services.<sup>3</sup>

##### *India*

India has become the largest exporter of computer and information services of the

3. ITC Fact Sheet: Creating Sustainable Exporter Competitiveness: IT and ITES Sector in Bangladesh. See [www.intracen.org/projects/ntf-ii](http://www.intracen.org/projects/ntf-ii).

developing countries and this remarkable achievement has occurred in a relatively short period of time. Services now contribute around two-thirds of the growth of India's GDP. India is the iconic example of a country where services have allowed it to leap-frog over the manufacturing sector and rise above infrastructure and institutional constraints in order to become a global player in world services markets. Exports of services, especially ITO offshoring, have played an important part in India's recent growth.<sup>4</sup>

Since the steps taken toward import liberalisation in the early 1990s, India's share in world services exports has grown from 0.5 to 2.5 per cent (Goswami et al. 2012). The export segments that have grown the fastest are those of computer and information services and other business services, which are closely related to ICT and ITeS exports. In terms of total exports of software from India, 77 per cent of these were computer services (ITO services) in 2008 (US\$23 billion), with a small amount in software product development. This implies that India is still on the low to medium end of this service category. Within ITeS exports, the lion's share was made up of BPO services (US\$7 billion), with engineering services about one-sixth of the total (US\$1.1 billion). Thus, as shown in Table 3, most of India's exports of services are destined for incorporation into GVCs in other destinations, primarily in Canada and USA.

A large proportion of the service-exporting firms in India are small. However, the large exporting firms account for four-fifths of the export revenue generated. Also striking is the fact that

**Table 3. Destination of Indian software services exports, 2002/03 and 2007/08**

Country	Share of exports (%)	
	2002-03	2007-08
USA and Canada	63.7	64.0
Europe	23.7	26.6
East Asia	5.9	3.0
West Asia	1.9	0.5
South Asia	0.9	0.5
Australia and New Zealand	1.5	1.6
Latin America	0.2	
Others	2.2	3.8

**Source:** Reproduced from Goswami et al. (2012: 98)

Indian computer and software firms are not only exporting services via cross-border delivery, but have also begun to carry out exports through investing abroad (mode 3). Goswami et al. (2012: 102) write that the increase in outward FDI in services since the mid-1990s has been largely attributable to the ICT industry as well as the broadcasting and publishing sectors.

Aside from possessing abundant human talent and skilled labour, government policies in India have played a key role in shaping India's strong performance in services. India has been able to overcome its well-known deficiencies in infrastructure, partly because information technology has allowed it to trade services at a distance at virtually no cost. But Goswami et al. (2012) argue that government policies directed to foster

4. The computer service sector constituted about 80 per cent of business services in India in 2009 and is the fastest-growing sector.

development of the ICT sector have been just as important, including lowering tariffs on computer and software imports; the establishment of export processing zones in the form of software technology parks; more liberal foreign equity limits for investment in the software and electronics sectors; investment in education and human capital through the establishment of several research institutes (such as the Indian Institute of Engineering), private training institutes and organisations for software development; a strong policy on intellectual property right enforcement through the 1984 copyright act; and the creation of an industry software organisation, the National Association of Software and Service Companies to work with the government to promote the sector's interests. Another factor, and specific to the Indian case, has been the contribution of the Indian diaspora to investment in knowledge-intensive sectors in India (Goswami et al. 2012: 108–114).

### *Malaysia*

Malaysia has also seen its services exports increase in the ITC area, where it has also become a growing participant in the network of GVCs in East Asia. The growth of services exports has not been a chance phenomenon, but rather the direct result of government policy targeted to encourage FDI in specific service sectors, including not only ICT, but also medical tourism and Islamic finance. ICT services exports grew from 1.2 per cent to 3.4 per cent of total services exports between 1993 and 2008 (Abidin et al. 2012). These exports have largely been the result of offshore investment and are destined for GVCs in the East Asia region and beyond.

Like in the case of India, but perhaps to an even greater degree, the successful

growth of ICT services (and ITO offshoring services) has benefited from policy decisions with a long-term perspective. In 1996, the Malaysia government created the multimedia super corridor, a designated zone with the express purpose of attracting FDI and local ICT companies in order to build a competitive computer/information services industry. Incentives such as 100 per cent foreign equity ownership and no restrictions on the employment of foreign workers were provided, as well as technical skills and training in the ICT area. By 2009, the number of firms in the corridor numbered 2,520, of which one-quarter were foreign companies, including joint ventures. Cumulative FDI in the corridor amounted to US\$1.65 billion (Abidin et al. 2012: 177).

In addition to the multimedia super corridor, other factors cited by Abidin and colleagues to explain Malaysia's success in developing its offshore services sector include its conducive business climate (Malaysia ranked number 23 in the World Bank's 'ease of doing business' ranking in 2010), its unilateral liberalisation policy in key sectors including higher education institutions and the strategic position of Malaysia that benefits from its geographic proximity to the entrepôt of Singapore as well as its proficiency in the English language. Lower labour costs compared to Singapore, offered with comparable infrastructure, give it an advantage. A sound and transparent regulatory framework for services with regular dialogues between the regulators and the providers, together with well recognised standards for quality assurance has worked to underpin export success (Abidin et al. 2012: 175–189).

### *Uganda*

UNCTAD's *National Services Policy Review* of Uganda (2011), shows that the services sector has consistently demonstrated the highest growth potential of any sector in the Ugandan economy. In 2008–09, the services sector was reported to have grown by 9.4 per cent, compared with 7.2 per cent for manufacturing and 2.6 per cent for agriculture. While overall services exports have been erratic, Uganda is one of Africa's better performers in the export of ICT-related services, which are reported to have grown from US\$0.7 million in 2003–04 to US\$31.5 million in 2006–07, a 45-fold increase. This makes the ICT sector one of Uganda's best export growth performers. Other business services were the second highest performing growth sector, accounting for US\$38 million of export revenue. The primary markets are the EAC and the EU.

UNCTAD identifies these results as, in part at least, the result of targeted government policy focus, including initiatives such as introduction of a national ICT policy framework, establishment of a ministry of information and communications technology and active promotion of the ICT sector through the Uganda Investment Authority. A number of small niche business process outsourcing firms established a decade ago have proved remarkable success stories, for example Cayman Consults Ltd, which specialises in accounting and data entry and is now one of the leading BPO firms in the East Africa region. Clear-accented English language and cultural disposition to customer focus have been cited among the factors contributing to competitive advantage and attractiveness as an investment destination for the call centre industry. Conversely, detracting from

competitiveness are irregular and unpredictable electricity outages, high internet connectivity costs, skills shortages for value-added work and weak intellectual property right legislation.

### *South Africa*

According to the World Bank study (Dihel et al. 2012: 262), South Africa has a BPO sector worth US\$960 million annually, which is forecast to grow to US\$1.9 billion by 2015, and to move up the value chain beyond financial services, into desktop publishing, software development and legal process outsourcing. South Africa certainly seems to have the potential to compete with some of the strongest global exporters of BPO, having already attracted some of the world's top investors in the sector.

The World Bank study notes that among the key factors influencing South Africa's success was the crafting of deliberate policies and strategies to help create an enabling business environment and cut telecommunications costs. A government assistance and support programme was launched for the accelerated development of the BPO sector including, inter alia, supporting effective marketing of South Africa as a competitive BPO location and strengthening the domestic sectoral business association to be capable of mobilising and representing the key industry stakeholders.

The World Bank study stresses the importance of a concise and clearly articulated export promotion message, with dedicated personnel to deliver it, given how dynamic and changeable conditions can be in this fast-moving industry. The authors suggest that investor decision-making processes are affected by issues such as business culture and the general professionalism of parties involved and

that this factor should never be underestimated. This is especially important given the need to overcome persistent perceptions of difficulties in doing business in

Africa: South Africa, in particular, has been fraught with the negative perception of crime as well as rising inflation and volatility of the local currency.

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## 7. Logistics services: the key to connectivity in global goods value chains

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As the examples cited in earlier sections testify, GVCs can only operate efficiently if the local business and trade environment enable them to do so. Insufficient attention has been paid to policy measures to minimise ‘choke points’ in connectivity between the various local links in the chains. With respect to trade in goods, logistics inefficiencies can be a determining factor in whether or not participation in GVCs is viable.

### 7.1 Logistics inefficiency as a barrier to goods supply chain operation

One of the key factors affecting whether or not local firms can compete for access into global goods value chains is the efficiency of local logistics services. Even if tariffs on exports are low, firms will not be able to compete if they confront high costs and inefficient logistics.<sup>5</sup>

In this context, transport costs and border operations hold the key. For goods, distance to markets can be overcome, but only if the operation of port/airport

facilities and accompanying services (ICT services, customs clearance procedures and low-cost inventory systems) can compensate for the greater distance with greater efficiency.

‘Logistics’ have been defined more or less broadly, but all agree that a core definition of logistics must include all aspects of border management (for example, speed and automation in clearance procedures through custom), efficient port operations and cargo handlers, as well as the trade-related infrastructure in place, including the efficiency and quality of transport services, together with port handling, warehousing, etc. We could add distribution, telecommunications and express delivery services to a logistics package.

These factors, all of which contribute to the services dimensions of goods supply chain performance are usually not put together and considered in a holistic manner as crucial factors for GVC operation by policy-makers. But they can make all the difference. For example, manufacturing an aeroplane today needs over 50,000 suppliers whose inputs of goods

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5. Freund and Rocha (2011) estimate that every day it takes a consignment in Africa to get to its destination is equivalent to a 1.5 per cent additional tax.

and services from around the world must be combined in the most cost- and time-efficient way possible. Firms in countries with inefficient logistics infrastructure and operation will not be called upon to participate in such networks as their logistics systems will not allow them to meet these just-in-time deadlines in a reliable manner.

For governments, improving logistics/trade facilitation is a key challenge, not least for its implications for GVC operation. The Logistics Performance Index (LPI), produced by the World Bank for over 150 countries, captures different dimensions of the determinants of their supply chain performance. The LPI shows how customs-clearance procedures and trade-related infrastructure, as well as key services, affect the performance of firms. This includes timeliness of delivery and the ability to track and trace consignments. Over-restrictive or inefficient policies affecting these factors will impede supply chain operation by introducing discontinuity and affecting reliability.

Of the 153 countries in the latest LPI, released in 2012, 30 are Commonwealth members (of which 25 are developing and small Commonwealth states). Table 4 lists these 30 countries in terms of their ranking on the overall LPI score, with Singapore at the top of the list, being the world's most efficient economy for its logistics operations. However, 22 out of the 25 Commonwealth developing and small countries find themselves in the bottom half of the LPI list, falling after the 70 mark, indicating that logistics operations are less efficient than the world average.

Table 5 shows the breakdown in the six factors behind the overall LPI ranking, allowing for a better appreciation of which areas are most in need of improvement in

**Table 4. Logistics performance for Commonwealth countries, 2012**

Country	Rank	Score
Singapore	1	4.13
UK	10	3.9
Canada	14	3.85
Australia	18	3.73
South Africa	23	3.67
Malaysia	29	3.49
New Zealand	31	3.42
India	46	3.08
Pakistan	71	2.83
Mauritius	72	2.82
Malawi	73	2.81
The Bahamas	80	2.75
Sri Lanka	81	2.75
Dominican Republic	85	2.70
Tanzania	88	2.65
Namibia	89	2.65
Maldives	104	2.55
Cameroon	106	2.53
Ghana	108	2.51
The Gambia	118	2.46
Nigeria	121	2.45
Kenya	122	2.43
Fiji	123	2.42
Jamaica	124	2.42
Solomon Islands	126	2.41
Papua New Guinea	128	2.38
Guyana	133	2.33
Rwanda	139	2.27
Lesotho	142	2.24
Sierra Leone	150	2.08

**Source:** World Bank Logistics Performance Index (2012)

the Commonwealth developing and small countries. These factors are: customs, infrastructure, international shipments, logistics quality competence, tracking and

**Table 5. Commonwealth member countries' rankings on inputs into the LPI index**

Country	Customs	Infrastructure	International shipments	Logistics quality and competence	Tracking and tracing	Timeliness
Singapore	1	2	2	6	6	1
UK	10	15	13	11	10	10
Canada	17	12	18	13	14	3
Australia	16	18	28	16	19	17
South Africa	26	19	20	24	16	20
Malaysia	29	27	26	30	28	28
New Zealand	20	29	33	34	27	48
India	52	56	54	38	54	44
Pakistan	46	71	68	72	90	83
Mauritius	72	59	113	85	69	52
Malawi	77	64	48	60	102	88
The Bahamas	57	66	81	80	87	98
Sri Lanka	71	89	50	68	86	110
Dominican Republic	76	77	73	76	110	100
Tanzania	130	105	59	94	77	99
Namibia	54	69	114	88	67	144
Maldives	119	93	117	81	118	102
Cameroon	96	121	128	114	103	6
Ghana	103	136	76	83	133	125
The Gambia	111	147	98	100	75	142
Nigeria	146	118	105	102	128	105
Kenya	136	130	88	118	130	113
Fiji	137	123	122	136	112	85
Jamaica	123	119	121	132	117	107
Solomon Islands	95	137	118	144	122	93
Papua New Guinea	145	126	131	135	106	95
Guyana	113	131	129	122	140	136
Rwanda	127	148	138	147	121	124
Lesotho	143	132	143	112	148	131
Sierra Leone	153	88	152	151	141	150

Source: World Bank Logistics Performance Index (2012)

**Table 6. World Economic Forum enabling trade index: selected Commonwealth countries**

Country	Score	Rank	
		2012	2010
Singapore	6.14	1	1
New Zealand	5.34	5	6
Canada	5.22	9	8
UK	5.18	11	17
Australia	5.08	17	15
Maldives	4.90	24	30
Mauritius	4.62	36	33
Cyprus	4.61	37	31
Rwanda	4.35	51	n/a
Botswana	4.31	54	53
South Africa	4.13	63	72
Sri Lanka	3.95	73	99
Namibia	3.92	75	70
Jamaica	3.89	79	74
Malawi	3.79	85	83
Dominican Republic	3.78	87	73
The Gambia	3.74	91	82
Tanzania	3.69	94	97
Mozambique	3.65	97	93
Ghana	3.59	99	96
India	3.55	100	84
Kenya	3.52	103	105
Guyana	3.52	104	109
Bangladesh	3.48	109	113
Lesotho	3.41	113	101
Pakistan	3.39	116	112
Cameroon	3.28	118	115
Nigeria	3.13	123	120

**Source:** World Economic Forum Enabling Trade Index (2012)

tracing and timeliness. Although the rankings vary from country to country according to the different factors, in general terms

those 22 Commonwealth states falling below the world LPI average ranked poorly in most or all of the six factors. Addressing these deficiencies, particularly the input of more efficient transportation services, will be critical for these countries if they wish to engage in globalised production networks.

In a similar manner, the World Economic Forum's enabling trade index (ETI) captures four major aspects relevant to the operation of supply chains, namely market access, border administration, transport and telecommunications infrastructure and business environment, and ranks 132 countries according to their aggregate performance on each, and on all four aspects collectively. Table 6 highlights the 22 Commonwealth developing and small countries and their ranking in the ETI, as well as their individual scores on these four aspects relevant to the operation of supply chains. Again, efficient services (transport and telecommunications) are missing for many of the countries listed, without which their participation in GVCs for goods, and also services, is necessarily compromised.

These two different but complementary indices point out the main inefficiencies in goods supply chain operations today and, in corollary, the main areas needed for improvement on a country-by-country basis. Bringing about improvement in logistics would result in tremendous benefits for Commonwealth developing and small countries.

## 7.2 Adopting a 'holistic' approach to enabling trade

To be most effective, governments need to approach logistics in a 'holistic' manner. In the trade facilitation context, this would mean bringing together a variety of relevant services sectors

and subsectors (cargo handling, storage, warehousing, agency services and related ancillary services, as well as freight services: air, road, rail, maritime and express/courier) to consider these services in a bundle, with efforts made to facilitate trade including via customs and border procedures across the whole value chain.

At the national level, a focus on logistics would mean efforts by governments to improve the economic operating environment for firms in all of the above relevant areas rather than by continuing to focus primarily on border barriers.

Many of the policies that artificially 'break' the supply chain are regulatory in

nature. Progress must also be made to address logistics improvement through international co-operation. An important element is agreeing on regulatory principles, consultation processes that allow the identification and elimination of choke points, and specific performance targets (for example, time-to-release commitments and a common list of data requirements for shipments). The business community has likewise advocated a 'whole of the supply chain approach', addressing inefficiencies in a variety of connected sectors and subsectors, such as cargo handling, storage, agency services and freight services.

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## 8. Enhancing national services export capability

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### 8.1 Factors relevant to services competitiveness

The opportunities offered by the new pattern of world trade in the form of value chains make it imperative that economies give greater attention to their relative competitiveness in services, or to put this another way, to their ability to attract services tasks for the global market onshore.

It is important to note that the World Bank (Goswami et al. 2012) reports that openness of an economy's own policies affecting trade, investment (inwards and outwards) and labour mobility in services are important for the sector's own performance, as well as for the rest of the economy. This means that competitiveness in services can be greatly enhanced by the actions of individual countries, driven by policy choices

and efforts made to create an environment that will enable and encourage trade.

Because so many of the constraints to services trade are behind-the-border measures, the efficiency of domestic regulatory regimes is also highly relevant to participation in services trade. In services, regulatory reforms have direct effects on markets and trade, on access and entry of new service providers (both domestic and foreign), on the scope of business operations and, ultimately, on the sector's growth and performance overall, as well as on manufacturing sectors that rely heavily on services. The regulatory reform agenda is also a trade agenda item. It is hard to disentangle one from the other, especially in the case of the services sector.

McCredie and Findlay (2011) refer to rent-creating (limiting market entry) and cost-creating (regulatory compliance)

trade barriers. Rent-creating effects are more relevant to goods trade while for services the cost effects are most significant. Addressing cost-creating barriers has a positive impact for domestic producers as well and studies suggest that services trade liberalisation results in a rise in the level of domestic productivity (PECC-ADBI 2011: 28). The consequences of greater openness for the competitiveness of the sector as a whole are important. Services producers are themselves significant users of other services, tourism and air transport, for example, or telecommunications services used in business processing. A more open sector also offers more variety to users of services. Furthermore, a more competitive services sector contributes to productivity growth elsewhere in the economy.

The World Bank also finds that another important factor in service sector performance is institutional quality, as measured by the degree of corruption in government processes and the extent of rigidity in employment law, as well as the economic freedom index and the scope for active private-sector policy advocacy and input into policy-making. Institutional quality matters because of the support it provides for structural change and the reduction of uncertainty around contracts and the opportunities and costs of setting up new businesses.

The drivers of services competitiveness have been summarised in a framework of eight factors proposed by the Asia-Pacific Economic Cooperation (APEC) Business Advisory Council (ABAC 2011). This framework, presented in Box 4, draws on not only the empirical results from a variety of developing country case studies undertaken by the World Bank, but also firm-level evidence and business

perception surveys emerging from business associations in the APEC region.

The above framework suggests that there are many policy variables relevant to services competitiveness, and therefore much that governments can do, both individually and in a concerted manner, to enhance the opportunities for broader participation in global and regional supply chain activity. Some of these variables are considered in more detail below.

## 8.2 Importance of services infrastructure for entry into GVCs

The factors affecting competitiveness in services generally and the factors affecting entry specifically into services supply chains, are obviously closely related. World Bank case studies on developing country services exports all confirm that because services are more skills-intensive than the other sectors, knowledge economy infrastructure and an environment that nurtures talent, skills and ideas are critical in attracting work onshore. Figure 19 shows the evidence of a relationship between digital infrastructure and services exports, although internet penetration in the importing countries obviously matters, possibly even more so.

In various case studies of services exporters human resource inputs have also been shown to be overwhelmingly important for the decisions of firms on where to outsource services work, and at what level of value-added. Factors including access to numbers of trained people, the quality of training and the associated wage structures are determinant in these decisions. World Bank research (Goswami et al. 2012) has

#### Box 4. Factors relevant to services competitiveness

- **Endowments, especially human capital (talent, education, skills, ideas and culture of customer focus)**

In this context business stakeholder interviews refer to the importance of vocational training while firms refer to the importance of multi- and cross-disciplinary education, including languages. Work by the World Bank shows that tertiary enrolment is significant in affecting services exports.

- **Investment in intangible assets (corporate intellectual property, e.g. copyright, business methodologies and brands)**

An analysis in the UK provides evidence of a deepening of intangible capital, contributing the bulk of growth in labour productivity. Firms refer to the importance of a supportive environment for innovation, including business process innovation.

- **Enabling digital infrastructure**

The World Bank confirms the importance of the quality of the telecommunications network and the extent of internet penetration (although this is not always critical).

- **Quality of institutions**

Several institutions identify transparency and the degree of corruption or the strength of the rule of law as being relevant to services competitiveness. The World Bank identifies the economic freedom index, which incorporates some of these variables into its rankings. Firms refer to the role played by institutions that undertake independent analysis of the costs and benefits of regulatory regimes.

- **Efficiency of domestic regulation**

Firms refer to constraints imposed by the complexity of the business environment. This includes rigidity or other inefficiencies in employment laws. For services companies, human capital costs are often 70-80 per cent of total cost, which means that everything to do with recruiting, training and deploying people is critical. Firms refer overwhelmingly to the burdensomeness of regulatory compliance costs and to the need for an environment which gives them flexibility to adjust to rapid changes in the marketplace.

- **Connectedness with the international market**

Being connected with the international market involves openness for trade as well as investment flows. Firms refer to the quality of export promotion efforts and toolkits in providing them greater opportunities to connect with supply chains. Also important for firms is the need for mutual recognition and interoperability of standards. Firms are increasingly concerned about the seamlessness of regulation across markets.

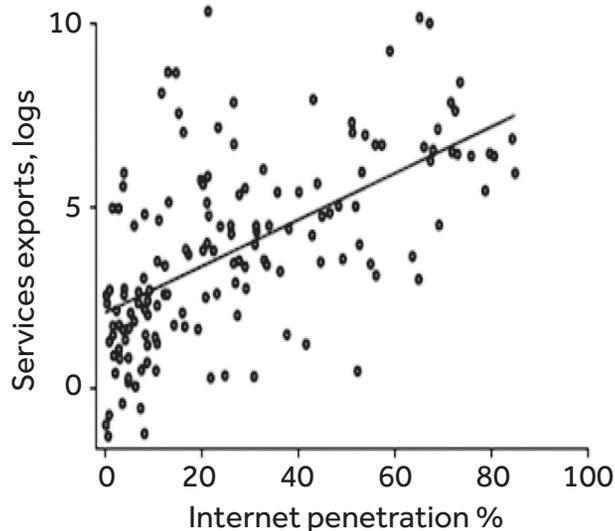
- **Services business stakeholder consultation**

Work by the World Bank suggests that services business groups (such as the National Association of Software and Service Companies in India and the Business Process Association of the Philippines) play a positive role in the development of services policy. In turn, firms stress the importance of stakeholder consultation mechanisms, for example the newly formed Indonesian Services Dialogue.

- **Policy focus**

The existence of a vision and roadmap for services on the part of government and policy-makers is highlighted by the private sector. In this context firms refer to the need for better services statistics and to the need for interagency co-ordination so that policies are coherent across departments. Studies by the World Bank are inconclusive about the potentially beneficial role of specific subsectoral targeting for services promotion.

Figure 19. Services infrastructure and services exports



Source: World Development Indicators, World Bank, and Goswami et al. (2012)

identified a correlation between human capital (as measured by tertiary school enrolments) and services exports. Chanda and Pasadilla (2011) similarly find that human resource inputs are important for ICT services firms, as illustrated in Figure 20. For services companies (where human capital costs are often 70–80 per cent of total cost) everything to do with recruiting, training and deploying people can be critical.

However, it is not simply a matter of salary costs. Numbers of graduates matter. Quality of graduates and discipline sets also matter. The global competitiveness index breaks this down, as shown in Table 7 for three Commonwealth countries.

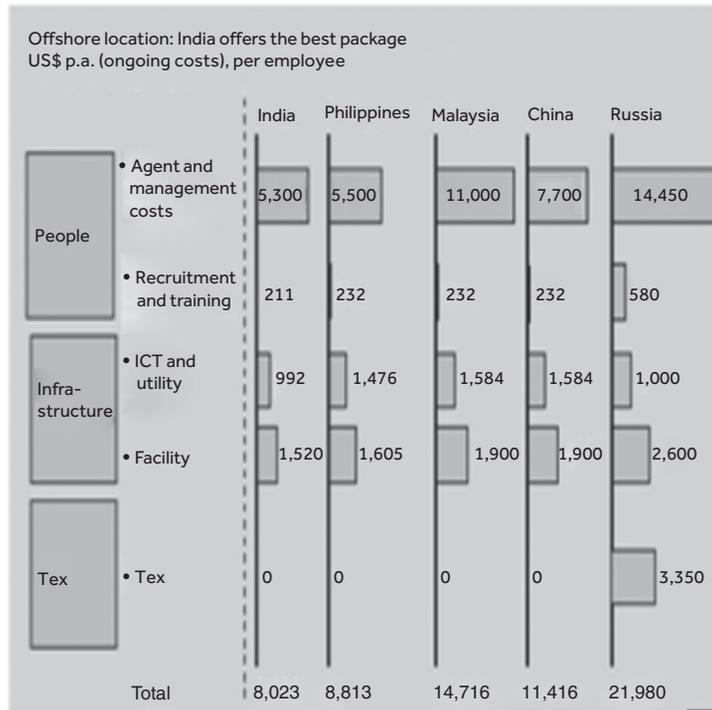
The AT Kearney location attractiveness index (2011) is a useful device for starting to analyse human capital factors affecting services supply chain entry. The position of individual countries in terms of their attractiveness for attracting services offshoring is shown in Table 8.

### 8.3 Attracting investment in services

UNCTAD's 2012 World Investment Report points out that services-sector FDI reached US\$570 billion in 2011. The WTO and IDE/JETRO study on trade in tasks (2011) also emphasises the staggering growth of services-related FDI flow over the past decade. Figure 21 shows the case of India, where FDI inflows in services grew from US\$0.8 billion in 2000 to US\$16.7 billion in 2008. It also shows the case of Singapore, where FDI flows into manufacturing slumped from US\$8.2 billion in 2000 to US\$1.5 billion, while FDI in services multiplied over the same period from US\$7.4 billion to US\$28.9 billion.

For developing countries, attracting investment is one thing. Ensuring local benefits from the investment is sometimes another, including identifying and expanding procurement opportunities for local SMEs. The priority, nevertheless, is to ensure that investment regimes are not sending

Figure 20. Attracting global services supply chains



Source: Chanda and Pasadilla (2011)

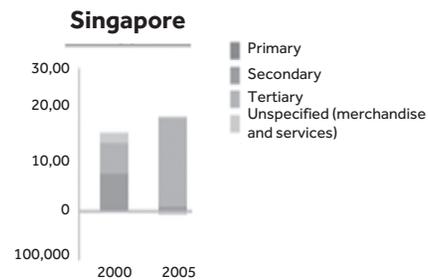
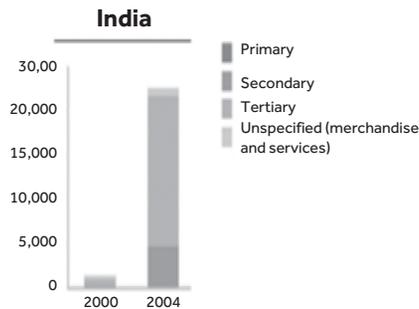
Figure 21. Growth of services foreign direct investment (FDI) flows to India and Singapore

**India**

FDI inflows went from US\$ 0.8 billion in services in 2000 to US\$ 16.7 billion in 2008

**Singapore**

FDI inflows to the manufacturing sector accounted to US\$ 8.2 billion in 2000, being slumped to US\$ 1.5 billion in 2005. During the same period, FDI flows to services (tertiary sector) increased form US\$ 7.4 billion to US\$ 18.9 billion



Source: UNCTAD (2012)

**Table 7. The global competitiveness index, selected indicators on skills (rank/133)**

Indicator	Rank (total=133)		
	Malaysia	Singapore	India
Quality of education system	23	1	37
Quality of maths and science education	34	1	22
Quality of management schools	34	5	15
Local availability of research and training services	26	14	32
Extent of staff training	16	2	34
Availability of scientists and engineers	33	14	4

Source: WEF (2009)

**Table 8. Attractiveness of countries in attracting offshoring activities**

Rank	Country	Financial attractiveness	People skills and availability	Business environment	Total score
1	India	3.11	2.76	1.14	7.01
2	China	2.62	2.55	1.31	6.49
3	Malaysia	2.78	1.38	1.83	5.99
4	Egypt	3.10	1.36	1.35	5.81
5	Indonesia	3.24	1.53	1.01	5.78
6	Mexico	2.68	1.60	1.44	5.72
7	Thailand	3.05	1.38	1.29	5.72
8	Vietnam	3.27	1.19	1.24	5.69
9	Philippines	3.18	1.31	1.16	5.65
10	Chile	2.44	1.27	1.82	5.52
11	Estonia	2.31	0.95	2.24	5.51
12	Brazil	2.02	2.07	1.38	5.48
13	Latvia	2.56	0.93	1.96	5.46
14	Lithuania	2.48	0.93	2.02	5.43
15	United Arab Emirates	2.41	0.94	2.05	5.41
16	UK	0.91	2.26	2.23	5.41
17	Bulgaria	2.82	0.88	1.67	5.37
18	USA	0.45	2.88	2.01	5.35
19	Costa Rica	2.84	0.94	1.56	5.34
20	Russia	2.48	1.79	1.07	5.34
21	Sri Lanka	3.20	0.95	1.11	5.26
22	Jordan	2.97	0.77	1.49	5.23
23	Tunisia	3.05	0.81	1.37	5.23
24	Poland	2.14	1.27	1.81	5.23
25	Romania	2.54	1.03	1.65	5.21

(continued)

**Table 8. Attractiveness of countries in attracting offshoring activities (continued)**

Rank	Country	Financial attractiveness	People skills and availability	Business environment	Total score
26	Germany	0.76	2.17	2.27	5.20
27	Ghana	3.21	0.69	1.28	5.18
28	Pakistan	3.23	1.16	0.76	5.15
29	Senegal	3.23	0.78	1.11	5.12
30	Argentina	2.45	1.58	1.09	5.12
31	Hungary	2.05	1.24	1.82	5.11
32	Singapore	1.00	1.66	2.40	5.06
33	Jamaica	2.81	0.86	1.34	5.01
34	Panama	2.77	0.72	1.49	4.98
35	Czech Republic	1.81	1.14	2.03	4.98
36	Mauritius	2.41	0.87	1.70	4.98
37	Morocco	2.83	0.87	1.26	4.96
38	Ukraine	2.86	1.07	1.02	4.95
39	Canada	0.56	2.14	2.25	4.95
40	Slovakia	2.33	0.93	1.65	4.91
41	Uruguay	2.42	0.91	1.42	4.75
42	Spain	0.81	2.06	1.88	4.75
43	Colombia	2.34	1.20	1.18	4.72
44	France	0.38	2.12	2.11	4.61
45	South Africa	2.27	0.93	1.37	4.57
46	Australia	0.51	1.80	2.13	4.44
47	Israel	1.45	1.35	1.64	4.44
48	Turkey	1.87	1.29	1.17	4.33
49	Ireland	0.42	1.74	2.08	4.24
50	Portugal	1.21	1.09	1.85	4.15

**Note:** The weight distribution for the three categories is 40:30:30. Financial attractiveness is rated on a scale of 0 to 4, and the categories for people skills and availability, and business environment are on a scale of 0 to 3.

**Source:** AT Kearney (2011)

inappropriate business signals and deterring valuable services trade opportunities.

When it comes to trade in services, it needs to be remembered of course that outward FDI is just as important as inward FDI. Malaysia provides a good example of a Commonwealth country which is actively exporting services via mode 3 – commercial presence – or offshore

investment in services. The examples below, along with Table 9, are drawn from the World Bank study (Abidin et al. 2012).

Air Asia, Malaysia's low-cost carrier, has joint ventures in both Thailand and Indonesia (Thai AirAsia and Indonesia AirAsia). Private hospitals and higher education institutions have also ventured overseas, for example, KPH Healthcare has

Table 9. Operations abroad of Malaysian banks, 2009

Bank	Number of subsidiaries	Location of subsidiary	Number of branches <sup>a</sup>
AmBank Group	3	Singapore, Indonesia, Brunei	3
CIMB	17	Bahrain, Brunei, Hong Kong, China, Indonesia, Myanmar, Singapore, Thailand, UK, USA	212
Maybank	14	Bahrain, Brunei, Cambodia, China, Hong Kong, Indonesia, Papua New Guinea, Philippines, Singapore, USA, Uzbekistan, Vietnam	342
Hong Leong Bank	2	Hong Kong, Singapore	2
Public Bank	5	Hong Kong, Cambodia, Vietnam, Sri Lanka, Laos	51
RHB Bank	4	Vietnam, Thailand, Singapore, Brunei	10

**Note:** <sup>a</sup> Includes representative offices and offshore banking unit

**Source:** Abidin et al. (2012: 170)

healthcare facilities in Indonesia, Bangladesh and Saudi Arabia and eight private higher education institutions in Malaysia have reported having branch campuses overseas, mainly in other developing countries such as Indonesia, India, China, Bangladesh and in Africa. Limkokwing University has reported the establishment of an affiliate in the UK. Malaysian services providers are also actively exporting both telecommunications and financial services via mode 3. The examples in Table 9, drawn from annual reports of Malaysian banks, illustrates this new reality.

#### 8.4 Facilitating services innovation

Similarly, services export success is dependent on innovation, so an industry/innovation policy that recognises services needs (Box 5) is relevant for competitiveness. Services activities tend, in addition, to be project based. This means that firms need flexibility to be able to innovate per project by moving people and ideas around quickly; virtual teamwork and cross-border collaboration can be important.

The bulk of the services sector everywhere is chiefly made up of SMEs. Increasingly it is SMEs in the services sector which are most engaged in global and regional value chains and business-to-business activities. This tends to require that firms, or even networked individuals in the case of the ICT sector, undertake significant business process innovation, in order to enter the relevant global supply chains. SMEs in particular need public efforts to facilitate such innovation.

#### 8.5 Services export promotion strategies

The nature of services exports and the variety of export delivery modes means that services firms need additional and 'different' promotional efforts and innovative national branding. Cross-border trade in services is usually aimed at attracting global work onshore, preferably of higher value-added. However, attracting this into local centres of excellence can seem, on the face of it, very different to attracting foreign buyers of goods. At least initially, this generally

### Box 5. Innovation matters for services export success

Services innovation:

- is driven by client relations to a greater extent than innovation in goods;
- takes place at the point of interaction between services provider and the client;
- is people-driven as well as laboratory-driven;
- does not necessarily offer economies of scale;
- involves a high level of interaction and interdependence between knowledge providers (such as research organisations) and knowledge users (such as service firms);
- does not necessarily take place as a specialised activity located in a separate part of an enterprise, but is tangled up with everyday creativity and design;
- requires both technological and non-technological inputs, including both social and natural sciences, the creative arts and humanities;
- suffers from inadequate access to collaboration opportunities between services providers and the education and research and development community; and
- is undermined by lack of digital infrastructure, disconnects between national standards, lack of interoperability and inadequate intellectual property protection

**Source:** McCredie et al. (2010: 70)

takes trade promotion agencies beyond their traditional comfort zones, into areas such as the cross-border movement of people, data and ideas, as well as capital.

Services export promotion requires a sustained focus on the facilitation of movement of people (skillsets) both onshore and offshore and a new focus not only on attracting foreign direct investment but on facilitating commercial presence/establishment offshore for local services firms, often via joint venture type arrangements. Effectively promoting services trade (e.g. offshore workers) can also sometimes require new regulatory bodies.

Official export promotion activities in many Commonwealth developing countries are poorly equipped and inexperienced to handle these complex new issues. Services trade promotion requires different skills than those required for the promotion of trade in goods, and a whole new toolkit. New trade promotional practices also need to be

benchmarked to best practice. A few official agencies are making improvements, and could positively share their experiences across the Commonwealth, if facilitated by activities planned at the Commonwealth level.

## 8.6 Building hubs of services excellence

To bring all the above factors together, growing a services industry can be understood perhaps to be about nurturing and branding a cluster of talent and expertise, and a customer focus, to which foreign clients can be attracted as a services investment destination.

Key policy ingredients are education policy and innovation policy, and understanding in concrete practical ways how getting these policy settings right is fundamental to attracting foreign investors. An important role for government is to provide the infrastructure required, which in the case of services includes, for example,

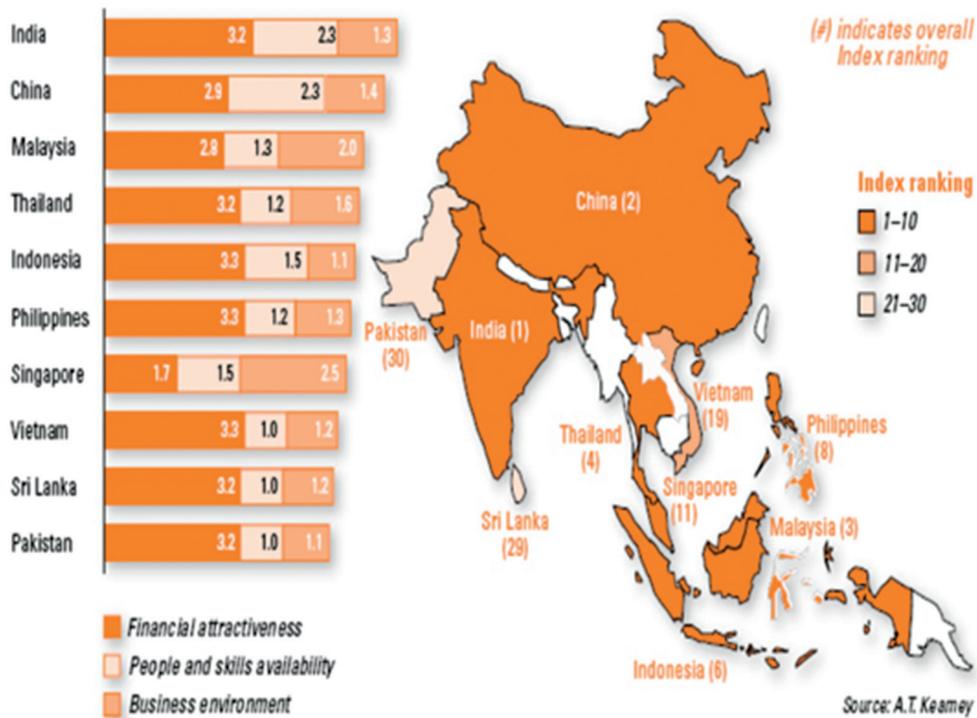
air transportation and broadband internet linkages. Government intervention to encourage compliance with international services standards and quality assurance processes is also extremely important. Ensuring an enabling domestic business environment and domestic regulatory efficiency, as we explore in the next section, is also vital. These factors are brought together in Figure 22.

It is also important to point out that development of services exports in Commonwealth developing countries has often been associated with deliberate government focus on specific sectors. This has been particularly the case for ICT services exports. The World Bank study on developing country services exports

(Goswami et al. 2012) notes that it has become quite common practice for governments to opt for the creation of software and high-tech parks, in which export-oriented firms can enjoy dedicated infrastructure and streamlined administration. In essence, these are the services equivalent of the export processing zones created for the goods sector. Such services parks similarly aim at solving the infrastructural and regulatory bottlenecks that the rest of the economy struggles with. The evidence is that investors respond positively to the heightened transparency and predictability of the regulatory environment inside the park.

The World Bank points out that one problem with this approach, of course, is

Figure 22. What makes a location attractive?



Source: Chanda and Pasadilla (2011)

that it denies the productivity benefits of regulatory reform to the rest of the economy. Nevertheless, it is worth mentioning a couple of examples of targeted policy intervention along these lines, which have succeeded in growing the local services industry.

In India, construction of software technology parks commenced in Bangalore, Pune and Bhubaneswar and was eventually permitted anywhere in the country. In 1995, about 400 companies were recognised as companies situated in such parks. By 2008–09, 8,455 operating units were registered, of which 7,214 were exporting (Goswami et al. 2012: 81).

Similarly, Malaysia's multimedia super corridor provided investor incentives, such as 100 per cent foreign equity ownership and no restrictions on the employment of foreign knowledge workers. In 2005, there were 1,421 companies established with corridor status. By 2009, the number of firms had grown to 2,520, of which 25 per cent were 100 per cent foreign-owned or 50/50 joint ventures (Abidin et al. 2012: 117).

While there is no doubt that these policies have delivered strong export outcomes, the World Bank study cautions against delaying economy-wide regulatory reforms, which usually prove safer than picking winners.

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## 9. Relevance of regulatory regimes

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The history of many services industries has tended to be one of a high degree of government intervention, including government ownership and control. This is in direct response to a widespread perception of market failure in many services activities. Some services activities have typically been seen as constituting 'public goods', justifying government service delivery, for example, health, education, urban bus transport or water supply (which in most countries are still seen as legitimate public services) or banking (which in most countries is now in the realm of the private sector). Other large infrastructural services, like telecommunications, energy distribution, airlines and shipping, have similarly tended historically to be seen as natural monopolies with capital resource requirements beyond the means of the domestic private sector.

Typically, all these services activities have consequently been highly regulated, usually to specify an appropriate standard of public service delivery and to ensure that the various public policy objectives are met. For example, banking and insurance everywhere are subject to stringent prudential controls, and telecommunications is typically subject to 'universal service' requirements, etc.

In much of both the developed and developing world, over the past two decades, many of these services activities have been reformed. Many have been privatised or at least opened up to private investment and competition, allowing a huge range of new services activities to enter the realm of the market place. However, there are cases where the regulatory regimes governing these activities have not kept up with the

rapid pace of change in the global business environment.

When regulatory regimes ossify, they deter innovation and become burdensome to domestic entrepreneurial activity, and hence an obstacle to domestic competitiveness and export opportunity. Services regulators need to understand and be responsive to the international consequences of domestic regulation.

There is strong international evidence of links between regulatory reform and productivity growth. Productivity is boosted by a focus on reforming those regulations that are overly prescriptive, poorly targeted, mutually inconsistent, duplicative, difficult to enforce or unduly costly or resource intensive for business to comply with. It is important to ensure also that there is a degree of harmonisation or seamlessness of regulatory practice between central, provincial and local administrative levels and, wherever possible, among close regional trading neighbours. Regulatory 'one-stop shops' make a big difference, especially to SMEs.

The World Bank study (Goswami et al. 2012) repeatedly points out that the single factor that has contributed to success in exporting services is associated regulatory liberalisation, including privatisation. Malaysia provides a number of examples, including for example in higher education, medical services, airline services and Islamic finance. In all of these sectors, the resulting enhancement of private sector capacity then paved the way for export. Inefficient or unnecessary regulations hamper competitiveness and usually restrict international providers from entering the domestic market. This has real negative economic consequences, since so many services are infrastructural or affect the competitiveness of other industries and sectors. Box 6 illustrates the infrastructural gains from telecommunications reform in Papua New Guinea.

From a competitiveness perspective, it is increasingly important that developing country trade policy officials, including trade negotiators, improve their understanding of their own domestic

#### **Box 6. Telecommunications regulatory reform in Papua New Guinea**

The introduction of competition into the mobile telephone sector in Papua New Guinea has led to near-universal coverage, following a rise of 700 per cent in the number of mobile subscribers since mid-2007 and a wider variety of services. Charges have fallen by 11 per cent at peak times for domestic calls and 51 per cent in off-peak periods.

The biggest consumers of digital services and the networks over which they travel are other services industries, such as financial services, healthcare providers and professional service providers. All of these services have been enabled by liberalising the telecommunications sector. In an economy such as Papua New Guinea with a difficult terrain, the benefits of this cannot be underestimated. Social interaction, such as the rate of response to medical emergencies, is better and mobile banking initiatives are now underway. The provision of market pricing information for rural commodities through mobile phone services will be valuable because the livelihood of the bulk of the population is from agricultural and fishing activities.

**Source:** Findlay (2011)

regulatory frameworks. Because many agencies are usually involved in regulating services, it is rare that any single agency, least of all the trade ministry, knows fully the regulatory regime for any particular service.

Even where awareness of the cost of inefficiency is high, governments can lack the capacity to implement badly needed reforms. This can reflect resistance from vested interests. Sometimes governments will need technical solutions and/or reform strategies. Often a simple guiding principle can facilitate reform, e.g. 'one regulation in and one regulation out'. New processes and/or institutions may also be needed.

Institutions tasked with improving domestic policy transparency and efficiency in many Commonwealth developing countries still lack the necessary capacity and expertise. Irregular or no regulatory review means there are no internal driving mechanisms for boosting services productivity and competitiveness. Even at the regional integration level, Commonwealth developing

countries do not yet appear to work closely enough together to benchmark appropriate and efficient regulatory practices for services. If Commonwealth developing countries are serious about exploiting the new opportunities to access global services value chains, there will need to be a stronger focus on benchmarking services regulatory practice and raising awareness of regulatory incoherence.

Services export success is not only a matter of appropriate regulatory settings, but also of standards. The interoperability of services standards is generally identified as a key priority for firms to operate across international markets. Focused efforts are needed to drive convergence of technical standards that are important for knowledge-intensive services. Commonwealth developing country governments, and their professional services associations, also need to put greater effort into concluding, and importantly, implementing, meaningful mutual recognition arrangements with trading partners.

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## 10. Recommendations for policy action to enhance participation of Commonwealth developing countries and small states in GVCs

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True interconnectedness will only be possible when the current lack of understanding of the services sector is addressed. Currently there is limited

public awareness of the economic significance of services for the development process and relatively little advocacy to raise that awareness. This is

not made easier by the lack of accurate statistical data and policy planning tools at a regulatory level. There are few visible developing country business champions in the services sector, weak stakeholder organisation and only a fledgling case study and anecdotal evidence base from which to work. Intergovernmental agency co-ordination has often been insufficient to enable articulated whole-of-government services roadmaps or strategies. Domestic regulatory regimes remain excessively burdensome to business and there is a widespread absence of supportive external dialogue to benchmark good regulatory practice. There are few institutionalised internal driving mechanisms to boost services productivity and competitiveness. Identifying and addressing the specific services choke points in GVCs which are impacting negatively on Commonwealth developing country participation in GVCs, ultimately requires that all these fundamental framework issues be addressed.

### **10.1 Fixing information gaps and raising awareness of services GVC opportunities**

Field work undertaken in Commonwealth developing countries, as reflected, for example, in case studies emerging from the services research offensive on the part of the World Bank, the regional development banks and other global and regional organisations, has made it clear that in most developing countries, knowledge and understanding of local services capacity and competitiveness is relatively poor. Official statistical data are in short supply and anecdotal industry

experience has not been systematically collected and made visible.

In general terms, it can probably also be said that throughout the Commonwealth developing countries, knowledge among citizens and officials, including trade negotiators, of the international services economy is similarly relatively limited. While this has improved, it remains much shallower than for goods. A business perceptions survey carried out in the APEC economies (USC 2012) showed that 57 per cent of business respondents felt that services were very much given only secondary attention compared with trade in goods.

#### **10.1.1 Services statistics**

To properly understand the importance of services to the economy they must be correctly measured statistically. Poor and unreliable services statistics contribute greatly to the knowledge gap relative to goods. This hampers empirical analysis and policy research on services. Disaggregated data are effectively unavailable in most Commonwealth developing and small countries, making sector-specific and detailed analysis very difficult and questionable.

Consequently, most Commonwealth developing countries, including their trade officials, know little about their services sectors, either in aggregate or at particular activity level. As well as compounding the malaise for services regulatory reform, this absence of information also means that trade officials tend to negotiate blindly on services. They also tend to assume that little capability or prospects exist to trade services internationally, or to enter GVCs, and hence see

few gains from liberalisation, whether unilateral or reciprocal.

### 10.1.2 Services competitiveness

There is pervasive ignorance and uncertainty about the main factors contributing to competitiveness in services, with marked gaps in the academic literature and the empirical basis for advocacy, partly due to the paucity of statistical data. This is beginning to be addressed, largely by the World Bank and other regional and global institutions, but needs still exist in Commonwealth developing countries. Such newly emerging information must be effectively customised and disseminated to Commonwealth developing countries.

### 10.1.3 International business in services

At a more immediate practical level, evidence is widespread of an imperfect understanding of how firms supplying services operate, and of the business environment, infrastructure and policy stance needed for them to grow. Related to this inadequate understanding of the workings of service firms is an insufficient knowledge of the domestic and international obstacles and challenges they face. This can be partly attributed to poorly articulation of their needs by suppliers, many of whom still do not clearly see themselves as part of the services sector. These problems are exacerbated in Commonwealth developing countries by most services firms being SMEs, which face particularly severe resource constraints in organising themselves and having dialogue with government.

### 10.1.4 Absence of policy planning tools

Insufficient services statistics has handicapped the development of appropriate policy research and analytical capacity in Commonwealth developing countries (generally the case throughout the world). This fundamental problem needs to be addressed to assist authorities better understand ways of attracting services work for the international market.

#### *Policy insight and recommendation 1*

Inadequate donor activity, individually or jointly, exists to fix the widespread information deficit on the services sector, on the services dimension of GVCs and on services trade opportunities for Commonwealth developing and small countries. **Improving the evidence base and disseminating the results should be a prime focus of Commonwealth technical assistance and capacity building.**

## 10.2 Policy and regulatory settings to build services capacity and competitiveness

### 10.2.1 Regulatory efficiency and coherence

Efficient regulatory settings can enable trade and inefficient regulatory settings can impose bottlenecks in the value chain creation process. Given the strong international evidence of links between regulatory reform and productivity growth, especially in the services sector, services regulators need technical assistance to expose them to the experience of other countries with respect to regulatory pitfalls and inefficiencies, as well as best regional practices.

Regulatory rules and administrative practices have a direct effect on service firms. Regulation can influence the structure of firms, where they locate, whom they hire and how they find markets and serve their clients. Poor regulatory and administrative practices can unnecessarily absorb a firm's productive resources, raise the costs of market entry for new firms, slow the rate of innovation and deter investment. Enhanced understanding is needed of how domestic regulations can have unanticipated impacts on domestic competitiveness in services, especially for SME exporters.

### 10.2.2 Services stakeholder consultation and dialogue

Many Commonwealth developing and small countries lack well-developed forums for services stakeholders to communicate with governments. Some new whole-of-services sector initiatives are underway to help facilitate more structured and regular interaction between private sector services stakeholders, trade and other relevant officials. But these efforts need sustained donor support to benefit from information exchanges, including on international best practice. The private sector must be a driving force for reform. While businesses have diverse and specific interests, most want more efficient and cost-effective services at home. Better (quality and cost) services enhance economic efficiency as they are large inputs into producing almost anything.

### 10.2.3 Conducting value-chain analysis

Drawing up a value chain map for complementary industries that add value

upstream or downstream from the core services competence can be helpful to guiding both policy and business settings. This is because such mapping can help identify the critical inputs to competitiveness and possible choke points in any distinct domestic services sector or subsector, such as infrastructure needs. Important aspects of this process include identifying the role of relevant educational and accrediting institutions and how to collaborate with them, as well as the role of relevant standard-setting and qualification bodies and how to meet their requirements. Outcomes of this sort of process can include clarification of the responsibilities of relevant trade-related ministries and the establishment of consultation and dialogue mechanisms through which to relate to them. This kind of value-chain mapping is an essential step in developing services industry roadmaps.

### 10.2.4 National strategies for services

A deliberate all-of-services sector policy focus is important for national productivity enhancement. Targeted subsectoral policies may also be useful in helping to develop niche export sectors, for example in ICT, education, health tourism or financial services. Targeted policies are best constructed in the context of an all-of-services overview. Articulation of a national strategy for services can therefore be helpful in ensuring consistency and coherence of policy settings.

The current situation is that policy-makers in many Commonwealth developing countries tend to have difficulty seeing where their national interests in

services lie. This uncertainty fosters an inclination to retain discretionary policy space rather than reform. There is also the common misperception in many developing countries that due to their limited, if any, services export opportunities, they must necessarily be defensive in trade negotiations. This approach sometimes reflects a lack of adequate information, of the vital link between services trade liberalisation and national growth, employment and development.

The lack of specific economic analysis and evidence weakens data-driven advocacy and evidence-based policy-making. It also diminishes the opportunities for stakeholders to articulate success stories. Instead, a strong preference develops for officials (and politicians) to retain policy space for possible future industry policy intervention, including rewarding vested interests that avoid structural adjustment, rather than reforming to reap the overall productivity and competitiveness gains.

A vicious circle exists between the overall lack of awareness and inadequate advocacy to raise awareness, and little services policy planning. Only a few Commonwealth developing countries, for example Malaysia, have any recent public dedicated all-of-services sector strategy, roadmap or vision either for local sector development or for international engagement.

#### *Policy insight and recommendation 2*

Commonwealth developing countries would benefit from greater opportunities to share and disseminate international experience regarding policy and regulatory settings that have proved conducive to attracting services work for the global market onshore. **Further**

**background research should be conducted and case studies collected to inform an active policy and regulatory dialogue at Commonwealth level.**

### 10.3 Minimising services inefficiencies in goods value chains

Inefficient domestic logistics, as well as other domestic services inefficiencies, will reduce the likelihood of success in efforts to participate in global goods value chains.

#### *Policy insight and recommendation 3*

Many services are infrastructural in nature and local inefficiencies in their supply are prejudicing opportunities for Commonwealth developing countries to participate in global goods value chains. **Achieving efficiency gains in logistics services and transportation and otherwise facilitating two-way cross-border trade in goods should be a sustained focus of Commonwealth developing country policy attention.**

### 10.4 Enhancing services value chain interconnectivity

Efforts to facilitate SME entry into regional and global supply chains will continue to prove ineffective unless simultaneous efforts are made to ensure connectivity at the technical level. Without ensuring cross-border connectivity in every sense of the word, small services firms will continue to struggle to move up the value chain and to meet the challenges of the international market. The business reality is that any disconnect in interoperability will generate a choke point in the cross-border supply

chain. Such choke points add to the operating cost of all firms. For SMEs, they often make cross-border business impossible.

#### 10.4.1 Digital infrastructure

When competing for entry into global and regional services value chains, broadband internet availability, cost and reliability are paramount. Global experience is that telecommunications reform and opening up is part of ensuring the investment in supply capacity required.

#### 10.4.2 Human capital

Creation of a positive human resource environment and a critical mass of skilled personnel can be shaped by national government policies that emphasise education and skills training.

#### 10.4.3 Services standards

Operating in any international market requires services providers to meet qualifications, licensing and technical standards and procedures. Commonwealth developing country officials and enterprises are underequipped with knowledge of about international and regional services standard setting and quality assurance bodies or relevant local and international business associations.

#### *Policy insight and recommendation 4*

The global evidence is that there are prerequisites for Commonwealth developing countries to enter global services value chains successfully, and that these become more critical at higher points of value-added. One prerequisite is digital infrastructure and, in particular, cost-effective and reliable telecommunications links. Other prerequisites include

technical interoperability, mutual recognition and global standards conformity and assurance. Investment in tertiary education and human capital is also vital. **Commonwealth technical assistance and capacity building efforts need to be expanded to cover services economy infrastructure.**

### 10.5 Trade policy co-ordination, negotiation and promotion

#### 10.5.1 Services trade policy co-ordination

Good internal trade policy co-ordination is especially important for services. In a globalising, more services-oriented world economy, setting trade policy has become far more complex. Trade policy now requires managing the nature and extent of foreign participation in all domestic economic transactions. Even greater account must be taken of the domestic dimensions of trade policy, including using it as domestic economic policy to improve overall productivity and economic efficiency. So for trade ministries the policy canvas has widened enormously.

Developments in international trade in services have also impacted on all domestic ministries. Those ministries with line responsibility for individual services (such as telecommunications) play a critical role in sectoral regulation and hence trade policy formulation. Other ministries or agencies have responsibility for horizontal or cross-sectoral matters relevant to trade (such as investment, immigration, intellectual property or government procurement).

Trade ministries everywhere need an institutional mechanism to communicate and consult with all these relevant ministries and agencies. While a formal mechanism is usually best, informal mechanisms can also operate satisfactorily. But, ultimately, a well co-ordinated and coherent whole-of-government trade policy position must be communicated both domestically and in international organisations. Inadequate trade policy co-ordination is endemic across the Commonwealth developing countries.

Few governments have a single department in charge of services. Instead, most Commonwealth developing countries have several different ministries dealing, in some form, with services. For example, ministries often deal individually with trade, communications and transport. A problem for developing trade therefore is that no single ministry is responsible for services, despite the economic benefits. The shared responsibility makes co-ordination extremely difficult, causing conflicts between sectoral and economy-wide issues, and impacting on the development of the services sector.

Co-ordination between ministries is therefore crucial for successful trade reform efforts to capture GVC tasks. This could be through officials from each ministry having dedicated responsibility to liaise with others on services development, especially in relation to trade. Alternatively, specific co-ordinating teams could be set up within government to work with all ministries. Whatever the solutions, for co-ordination to be achieved ministries must find ways to work together to develop beneficial services policy for the economy.

## 10.5.2 Services trade negotiation

As in the case of goods, the development of global services value chains is making many of the current trading rules for services irrelevant, as these rules were designed for application to services that are exported as final activities from national firms or service suppliers. The present normative framework for trade does not take into account the phenomenon of multiple suppliers and multiple locations for goods and services activities. These normative structures will need to be re-examined and modernised. This is as important for developing countries, if not more so, as it is for the advanced nations.

Already, the share of developing countries in services exports doubled over the past two decades; even the least developed countries now figure among the ranks of the world's services exporters. Despite the growth potential, however, developing countries' share in world service exports is still only 30 per cent; too few developing countries are yet taking advantage of the new opportunities to specialise in the export of services tasks.

There is evidence that global market share may be declining for some Commonwealth developing countries. Within the African, Caribbean and Pacific group, for example, while South Africa stands out as a major player, and Kenya, Jamaica, The Bahamas, Mauritius, Nigeria, Ghana, the United Republic of Tanzania, Barbados and Uganda all have services exports between US\$1 billion and US\$3 billion, the group as a whole has lost market share from about 3 per cent in 1975 to 1.9 per cent in 2010 (Chambras 2012).

From the perspective of SME services provider, struggling to reach the global market, this suggests that modes of supply should be as open as possible, especially modes 1 and 3 (cross-border trade and commercial presence) so that they can choose which of the avenues for producing and exporting their services activities along the value chain is the most cost-efficient. Commonwealth developing countries therefore need to redouble their efforts at regional integration in services. This will require a more intensive effort from the donor community to help developing countries understand the services aspects of regional trade agreements.

In the multilateral context, more effort is required to help Commonwealth developing countries understand their interests in the General Agreement on Trade in Services negotiations under the Doha Development Agenda. For example, little has yet been done even to explain the applicability and consequences for developing country interests, of the new least developed countries waiver on services. Likewise, there is next to no public information available to developing countries to enable them to follow the recent launch of plurilateral negotiations on services by the Really Good Friends of Services group.

*Policy insight and recommendation 5*

In value-added terms, services account for nearly half of world trade and the upward trend is clear. Services similarly dominate global investment flows. **Commonwealth country trade officials should be encouraged to give much greater attention to trade and investment in services, including in intergovernmental negotiation at the bilateral,**

**regional, mega-regional, plurilateral and multilateral level.**

*Policy insight and recommendation 6*

Participating in global services value chains necessarily requires openness to services trade, including to imports of services intermediates. **Commonwealth developing countries should prepare for greater internal policy co-ordination on services trade matters and for more intensive public private policy dialogue and associated advocacy on global services value chains.**

*Policy insight and recommendation 7*

Commonwealth developing countries need assistance to devise appropriate strategies to promote exports of services into GVCs. **Commonwealth donor countries should partner with other trade-related international organisations to showcase services export promotion best practice methods and tools.**

## 10.6 Investment and innovation

Investment policies need to be oriented towards attracting more inwards investment in services. Complementary policies might also be needed to help encourage adequate backward linkages into the local services economy and facilitate procurement opportunities for local services firms. Services export promotion efforts also need to focus on facilitating outwards investment in services, to take local services providers closer to their target markets. Meanwhile, the local business environment needs to be conducive to services innovation for the export market.

**Policy insight and recommendation 8**

Commonwealth developing countries need technical assistance to review their investment and innovation policy regimes. **Commonwealth capacity-building efforts should focus on investment and industry policy in tandem with trade policy reform.**

## 10.7 Development co-operation

The emergence of global services value chains offer potential new opportunities for latecomers to development to leapfrog from primary to tertiary industries. Landlocked countries do not need a coastline, nor access to a superhighway corridor nor geographic proximity to market, to participate effectively in these new IT-enabled services opportunities. For

remote small island countries, the infrequency of air transport links need no longer exclude them from the globalisation process. Language skills, customer focus, time zones and telecommunications links have become more relevant determinants of competitiveness. (Telecommunications costs are still significantly affected, of course, by smallness of market size and by remoteness, especially from under water sea cable connections.)

**Policy insight and recommendation 9**

Services should be given higher priority generally in development co-operation initiatives. **Commonwealth capacity building efforts should be directed to identifying and leveraging the factors that impact on competitiveness both at all-of-services level and in individual prospective services growth sectors.**

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