

Australian services trade perspectives: past, present and future

Presentation by Nicolas Brown to the Australian Services Roundtable Summit, Parliament House, Canberra, 16 July 2014¹

In the late 1990s, one of the co-authors of *Trading Nation*, Mike Adams, led a project within DFAT, which culminated in a series of books beginning with the exotic title, *Putting Australia on the New Silk Road*. He has a distinctly historical bent and came up with this name in large part to signal the links involving the exchanging of ideas, goods and technology between a pioneering dimension of trade in the distant past and a new age that was emerging – with electronic commerce at its heart. Many fascinating insights came out of the project, not least being the enormous potential enabling power of electronic commerce for services trade. Within DFAT, the project opened eyes to a new world appearing from over the horizon – a world that has been described in various ways, for instance as a technological revolution; the new digital age; the third industrial revolution.

All of these descriptions highlight the increased importance of knowledge-based service industries in national economies, and the transition from national economies to the global economy. The challenges posed by these changes have far-reaching implications for services trade and the way we need to approach it as policy makers and business people looking to make the most of the opportunities arising from this very new world.

This presentation makes three main points. They highlight why services trade must be on centre stage when talking about Australia's trade.

First, services trade is bigger than most people think because there are services inputs or 'embodied' services in just about all exports and imports and because substantial services are delivered in foreign markets through foreign-owned affiliates.

Second, the future of our trade will increasingly be about services as development continues in the Asia-Pacific.

Third, trade policy has an important role in securing the future of Australia's services trade.

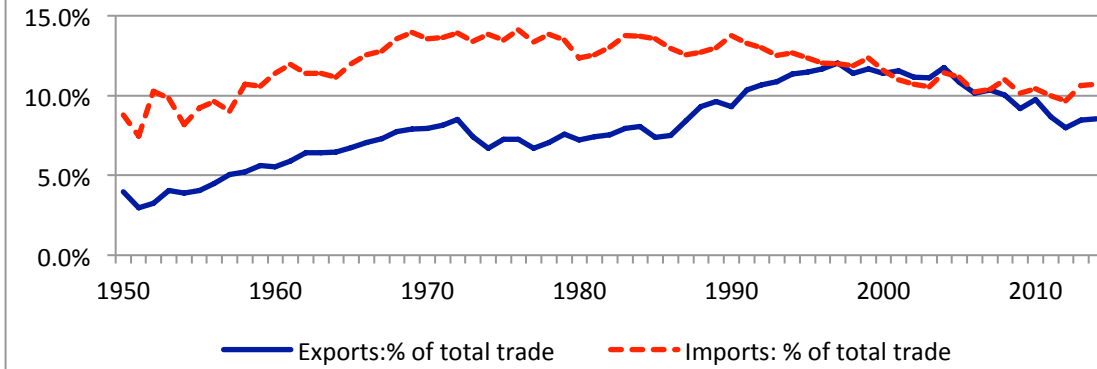
Services trade – important to Australia's trade and more than at first sight

Services have always been a significant part of Australia's trade. Until the second half of the twentieth century, Australia's services trade was dominated by freight and personal travel to and from Europe and North America. Services imports were substantially greater than exports.

Services trade has diversified and expanded markedly since the 1960s, especially on the exports side. Services exports rose from around 15 per cent of exports in 1960 to 20 per cent in 1990 and tourism emerged as a major export. In the 1990s, education-related services became a major export. Education is now among Australia's five largest exports. China is now the leading export market (figures 1 and 2).

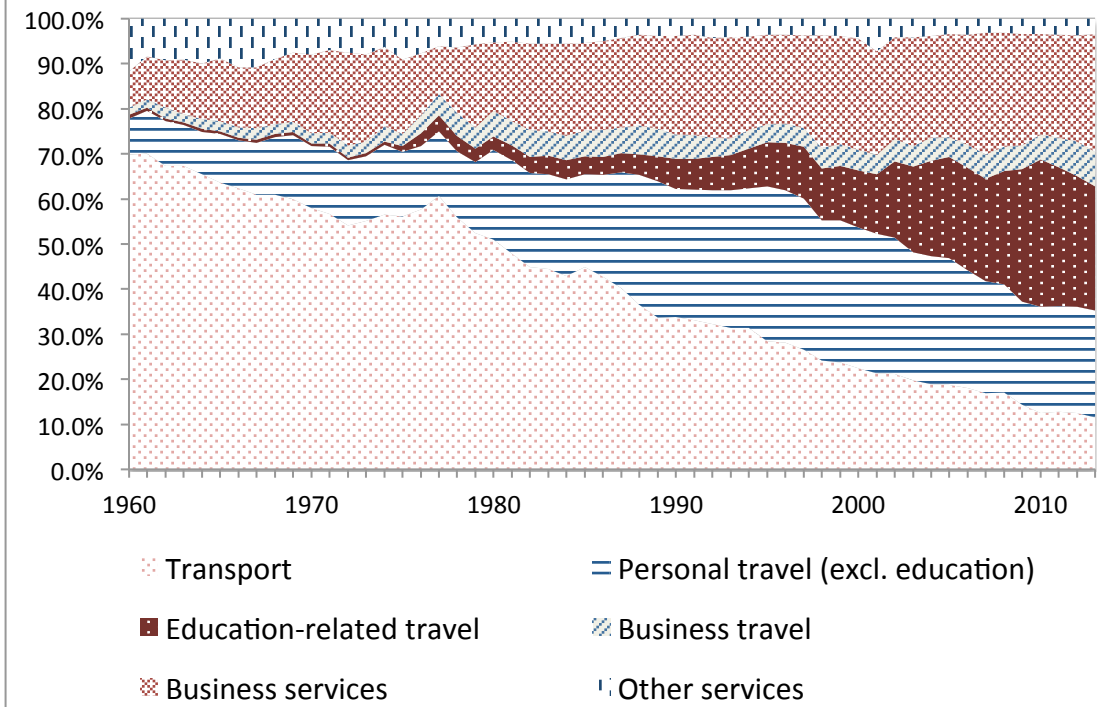
¹ This presentation draws extensively on the book *Trading Nation* (Adams, Brown and Wickes 2013). Nic Brown and the other authors are former senior staff of the Department of Foreign Affairs and Trade. (DFAT). This presentation benefited greatly from comments by Mike Adams and Ron Wickes.

Figure 1 Services exports and imports, Percentage of total trade

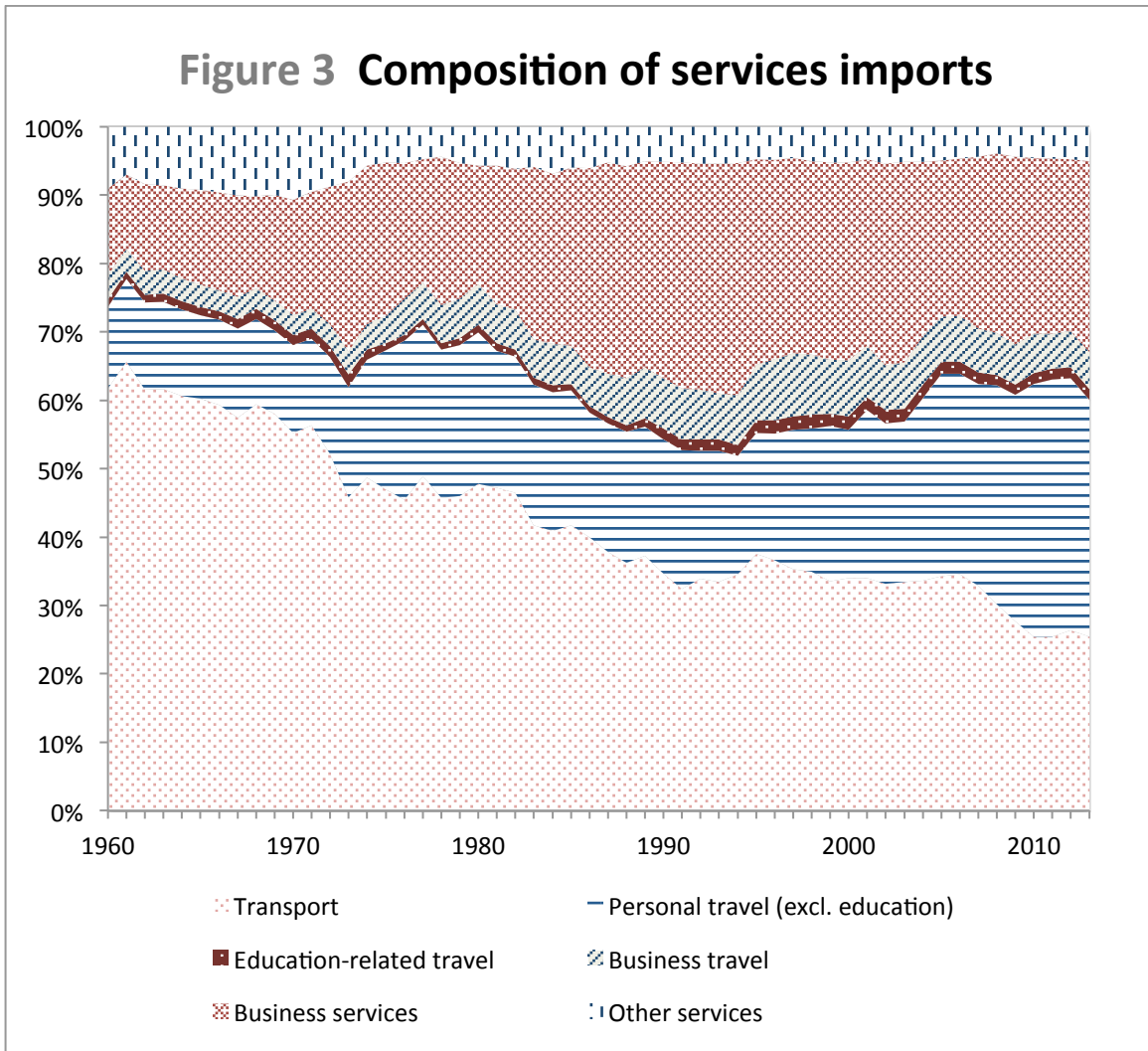


Source: ABS 5302.0

Figure 2 Composition of services exports



Source: ABS 5302.0



Source: ABS 5302.0

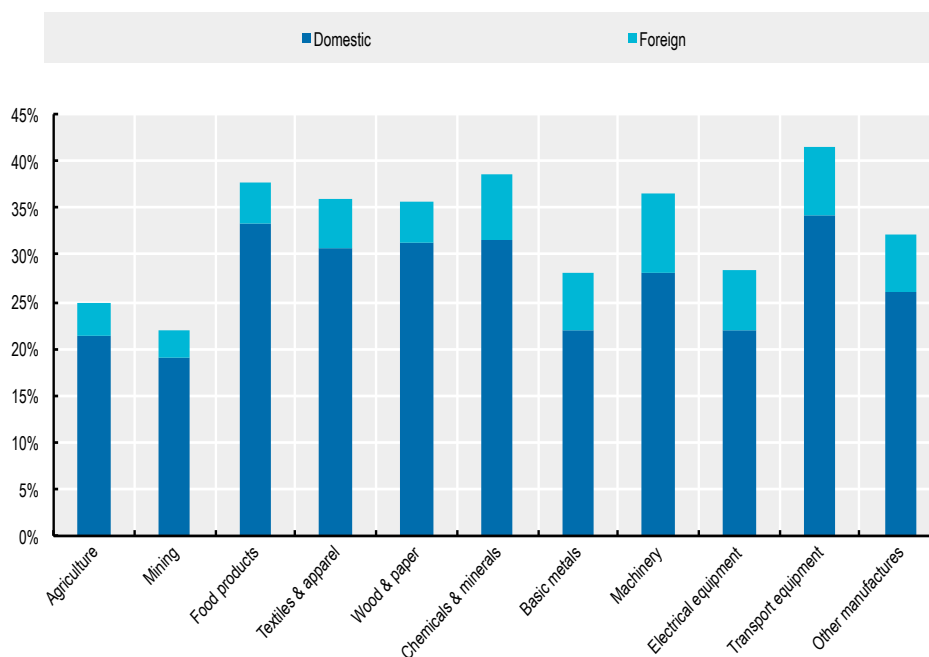
Travel-based services remain the mainstay of both services exports and imports, but business services, including financial, professional and technical services, have become a prominent part of services trade, thanks to technological advances, the opening up of Australia’s economy and its high quality services infrastructure and skills (figures 2 and 3).

But there is a lot more to services trade. Services industries contribute much more than just the exports and imports of services that are shown in conventional “balance-of-payments” based statistics.

First, the conventional basis for reporting trade does not show services’ contributions to non-services exports. Services industries contribute importantly to the production of exports from all sectors – most obviously in industries such as transport and stevedoring services, information and telecommunications services, electricity, construction, administration and design services.

This shortcoming in measurement is being addressed in a new WTO/OECD statistics project, which uses countries' input-output tables to unravel the contributions of different industries in different countries to the production of internationally traded goods and services. These statistics show that value added from domestic services sectors have consistently contributed over one third of Australia's exports. If the contribution of foreign services sectors is included, this rises to around 40 per cent. In 2009, these 'embodied' services contributed around 20 per cent of agriculture and mining exports and 25 per cent of many manufactures exports (figure 4).²

Figure 4 Services content of gross exports, by industry, 2009



Source:OECD & WTO 2013

Second, conventional statistics do not include services trade arising from the commercial presence of Australian affiliates based overseas and by overseas affiliates of foreign companies in Australia.

- The value of the level of Australian direct investment abroad in the services sector was around \$150 billion in 2012 and accounted for around 40 per cent of Australian total direct investment abroad. Income earned on the services component of this direct investment was close to \$10 billion. The finance and insurance sector was easily the most prominent with Australian stock of direct investment valued at \$115 billion. Other significant sectors included construction with assets of around

² 2009 is the most recent year for which the WTO/OECD trade in value-added statistics are available at time of writing.

- \$12 billion and property and business services (\$9 billion).
- In 2009-10, exports of financial services measured on the conventional balance of payments basis were valued at \$1.4 billion. But according to a special ABS survey, Australian finance and insurance affiliates produced services worth around \$39 billion. These included exports to third markets and Australia of \$3.8 billion, nearly treble the exports of financial services from Australia (Australian Bureau of Statistics 2011, Bingham 2011).
- The value of foreign direct investment in the Australian services sector was around \$235 billion in 2012 and a little over 40 per cent of total foreign direct investment in Australia. Income payable on this investment was around \$14 billion. Major sectors invested in included finance and insurance, wholesale and retail trade, property and business services, and construction.

Prospects for services trade

The outlook for services trade in the Asia-Pacific is always clouded by the uncertainties associated with expectations for the world economy. Nonetheless if attendant risks can be contained, the outlook is encouraging and services are set to become a more significant contributor to Australia's trade and to world trade in coming years.

Services play a key role in economic growth, including in developing countries, which need access to modern services to underwrite the quality of their development and growth.

- Services products typically have high income elasticities of demand (for instance, tourism and travel services) and should benefit from rising per capita incomes around the Asia-Pacific region.
- More urbanization of populations and growing middle classes, in particular in the emerging economies, will add to services trade growth.
- Technological change and improved communications structures in Australia and its trading partners, especially in Asia, will enable more services to be traded and boost demands for them through (i) growing demands of business for knowledge-based activities (including legal, financial and information technology services); (ii) further unbundling of functions in manufacturing and services, including divisions of functions across international borders³; and (iii) continuing (and probably accelerating) growth in internet-based trade and greater demand for services by businesses and consumers. Completely new 'born tradeable' industries could well be created.
- Foreign direct investment is likely to continue to increase, especially in East Asia given the high level of intra-regional connectivity. This will boost cross-border trade between affiliates and with other international commercial partners, while also lifting the level of services delivered through commercial presence.
- And, not least, services trade will be helped along to the extent that international trade agreements lower trade barriers, in particular behind-the-border regulatory barriers. This, along with the relentless advance of the digital economy, will enable more hitherto non-tradeable, and 'sparsely tradeable', services to become significant contributors to international services trade.

³ Interconnectedness will also make trade (including for services) more volatile. In particular, trade will be more vulnerable to disruptions or delays in provision of products along value chains.

Growth in Australia's services exports is certainly much needed. As John Edwards points out in his recent book, *Beyond the Boom* (2014), services exports will be needed to fill the breach if and when mining exports stop growing. Prospects are indeed improving, including for the mainstays – education services and tourism.

- Prospects for education services will be strengthened by regional demographics, urbanization and rising incomes, but there will be strong competition from other English language suppliers.
- Tourism Research Australia sees inbound tourism arrivals rising by around 4 per cent per annum on average from 2013-14 to 2022-23, with China, other East Asian countries and India the main growth markets (in numbers). New Zealand will remain the largest source, but China will become the largest market in dollars terms.

The exchange rate will be an important determinant of Australia's services trade performance. A lower rate would certainly provide a boost, while a higher rate would hold back growth, especially in more price sensitive areas such as tourism. That said, Australia's services exporters will be less threatened by a higher exchange rate to the extent that services trade moves towards areas where the focus is more on quality and capacity for innovation than on price, for instance in professional services. A high exchange rate and the accompanying greater purchasing power of the Australian dollar also should encourage greater commercial presence abroad.

Services and Trade Policy

Trade policy affects the development of Australia's services sector by contributing to domestic economic reforms, keeping domestic protectionist pressures (hopefully) at bay through targeted public diplomacy and by winning access to markets overseas.

Domestic reforms are vital if Australia is to take full advantage of the expected and possibly dramatic rise in Asian demand for services. Huge opportunities are in prospect, including to develop new areas of comparative advantage *providing* our economy is flexible enough, and we enrich our skill base, improve supporting infrastructure and roll back trade barriers.

The unfolding services story in countries like China, India and Indonesia and the fact that barriers to trade in services are much higher globally than for goods mean that services and investment must be core components of Australia's trade negotiations agenda. The 'Cinderella' role of services and investment in trade policy (ranking behind agriculture and manufactures trade) is long over.

Bringing down barriers to services trade is a formidable challenge. WTO bindings to constrain protectionist measures are low and weak among developing countries, though they are increasing in FTAs – developing countries are understandably wary about unintended consequences from opening services sectors prematurely.

The trade negotiations agenda

Australia's extensive trade negotiations agenda includes many opportunities to reduce or eliminate services trade barriers. The agreements with Korea and Japan signed this year are good indications of what can be achieved. They boost reciprocal access to services markets

through provisions that encourage investment, the movement of professionals and business people and mutual recognition of qualifications.⁴

On the multilateral front, there is some ground for optimism that the negotiations for the plurilateral Trade in Services Agreement (TiSA), which Australia is jointly leading with the United States and the European Union, can establish new benchmarks for commitments and rules for 21st century trade. The 23 parties to the negotiations account for around 70 per cent of global services trade.

Services and trade-related investment are prominent in the negotiating agendas of the two regional or ‘mega’ agreements Australia is involved in – the Trans Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP). The TPP negotiations, in which the United States has an obvious leading role, are also addressing competition policy and anti-corruption.

Over the next decade or so, mega agreements like TPP, RCEP and the Transatlantic Trade and Investment Partnership (TTIP) could establish benchmarks for broader international action that could, in turn, be injected back into the multilateral sphere.⁵

In all of this, of course, strategic factors are involved. A reality of trade negotiations is that they are always tied, albeit to varying degrees and in different ways, to foreign policy as well as to domestic policy imperatives. Key matters that may affect the future of TPP and RCEP include: the extent to which the US will accommodate wider interests beyond its own; the prospect of China joining the TPP; and whether TPP and RCEP ultimately divide the region or are building blocs in constructing the Free Trade Area of the Asia-Pacific (FTAAP).

- The US is the only country that is party to all of TiSA, TTIP and TPP negotiations and could well be placing itself to shape the next generation of services trade rules.
- Australia has a core interest in preventing TPP and RCEP becoming competitors. They both deserve strong support as potentially mutually reinforcing building blocs for a ‘Free Trade Area of the Asia-Pacific’ (FTAAP) – an idea whose time is coming if key countries can think beyond their narrow national interests.

⁴ The Japan-Australia Economic Partnership Agreement (JAPEPA) guarantees Australian services suppliers access to the Japanese market in key areas of commercial interest including financial, education, telecommunications and legal services. It provides Australia with outcomes equal to, or better than, the best commitments Japan has made in any of its other trade agreements.

The Korea-Australia Free Trade Agreement (KAFTA) also provides Australia with outcomes equal to, or better than Korea has agreed with any trading partner. It includes new market access for legal, accounting and telecommunications services and guaranteed access across a broad range of other services.

⁵ How such benchmarks could be incorporated in global rules is unclear. One possibility would be for useful regional benchmarks to be taken up by a wider sub-group of the WTO membership in sector-specific or issue-specific plurilateral negotiations. Another would be for watered down versions of regional benchmarks to be accepted by the whole WTO membership in forms that would still represent a strengthening of multilateral commitments. But however it is done, Australia has a long-term interest in regionalism strengthening the global trading system.

Another idea whose time is coming is an FTA with the EU. Taken as a whole, the EU is one of Australia's leading trade partners in services. An agreement with Europe would inevitably focus on trade and investment. Australia-EU trade is based on elaborately transformed manufactures (ETM) embodied services and other services and therefore is quite different from Australia-Asia trade. An Australia-EU FTA, along with supporting broadly based reforms to increase productivity, would increase Australia's services trade. It might also indirectly help to increase pressure on emerging countries, in particular China, to progress market-opening reforms in services.

Conclusions

Australia's services industries stand to benefit greatly from open international markets in services by delivering and purchasing high-value services. But there are two key riders. First, around three quarters of services imports are intermediate services - effectiveness as an importer is a prerequisite for effectiveness as an exporter. Second, competition for access to overseas markets is likely to increase.

These riders highlight why Australia must *build a more trade-focused economy*. Broadening and deepening the services trade base requires not just higher services productivity, but also more rigorous injection of international perspectives into reforming Australia's services sector.

As part of this, the role of services (including the value added perspective) needs to be *articulated and communicated better*. It should be part of a new trade narrative that highlights economies' mutual interest in opening their markets to services and related investment in the increasingly interdependent global economy with its increasingly fragmented international production and services delivery processes. In a world characterized by ever-finer value chains, inward and outward investment are equally important – a fact that should be reflected in government policy priorities.

Building regional relationships – cooperation with trading partners to strengthen connections to Asian markets - is part and parcel of harnessing more of Asia's business potential. This should involve a strong focus on economic reform, including on the raft of modern services needed to participate effectively in value chains. This can be done through stronger people-to people links and using forums like a reinvigorated APEC to guide and motivate unilateral reforms needed to facilitate freer trade flows, to advocate the benefits of trade liberalization and promote higher quality trade agreements and the multilateralisation of regionalism. An encouraging example of enhancing transparency is the Australian Productivity Commission's twinning program: under the auspices of APEC, the Commission works with agencies in China, Indonesia, Malaysia and Vietnam on elements of their structural reform programs.

Regional and bilateral trade agreements currently dominate *the international trade negotiations environment* though multilateral negotiations, including for the Trade in Services Agreement, remain important. Unilateral reform is the keystone and good trade agreements increase their benefits. Good multilateral agreements deliver the most benefits, but political and strategic realities dictate that bilateral and regional agreements will be around for some time yet. That said the recent emergence of negotiations for 'mega' agreements such as TPP and TTIP might open the way for more consistency among agreements and eventually provide benchmarks for multilateral agreements.

A last and important point is that economic cooperation should increasingly be an important part of putting in place agreements and arrangements to make the most of the opportunities that beckon for services trade. Trade involving emerging economies need to focus more on exchanges of ideas and capacity building to promote institutional links that facilitate structural change – change that recognizes and harnesses the realities of value-chain trading. This can lead, in time, to more open markets, including in services and also increase the chances of the grander visions coming more into play, through closer cooperation in the Asia-Pacific and from a reinvigoration of the multilateral agenda.⁶

More widely, the Services Roundtable's summit has highlighted, the complexity and differences in the structures and needs of services sectors within and across countries. International cooperation on services trade in forums like APEC, the G20 and the OECD - and in the gatherings of business groups within them - can be vital in developing and implementing enduring arrangements to underwrite growth of services trade and the increasing living standards it can deliver.

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Note: This presentation to the 2014 Australian Services Roundtable Summit, was by NICOLAS BROWN, who is a co-author of *Trading Nation* (Adams, Brown and Wickes 2013). Nic headed DFAT's branch responsible for analysis and strategic advice about trade and economic issues for five years to 2008. Nic joined DFAT in 1996 from the Department of the Prime Minister and Cabinet. He holds a Masters degree from the London School of Economics.

⁶ For example, RCEP will build upon existing economic cooperation arrangements between ASEAN and its RCEP FTA partners. This includes the arrangements in the ASEAN-Australia-New Zealand Free Trade Agreement (AANZFTA), which provide for economic cooperation projects and business outreach activities, including technical assistance and capacity building to developing ASEAN countries to assist in implementation of AANZFTA.