

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

James Hodge
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Summary

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

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

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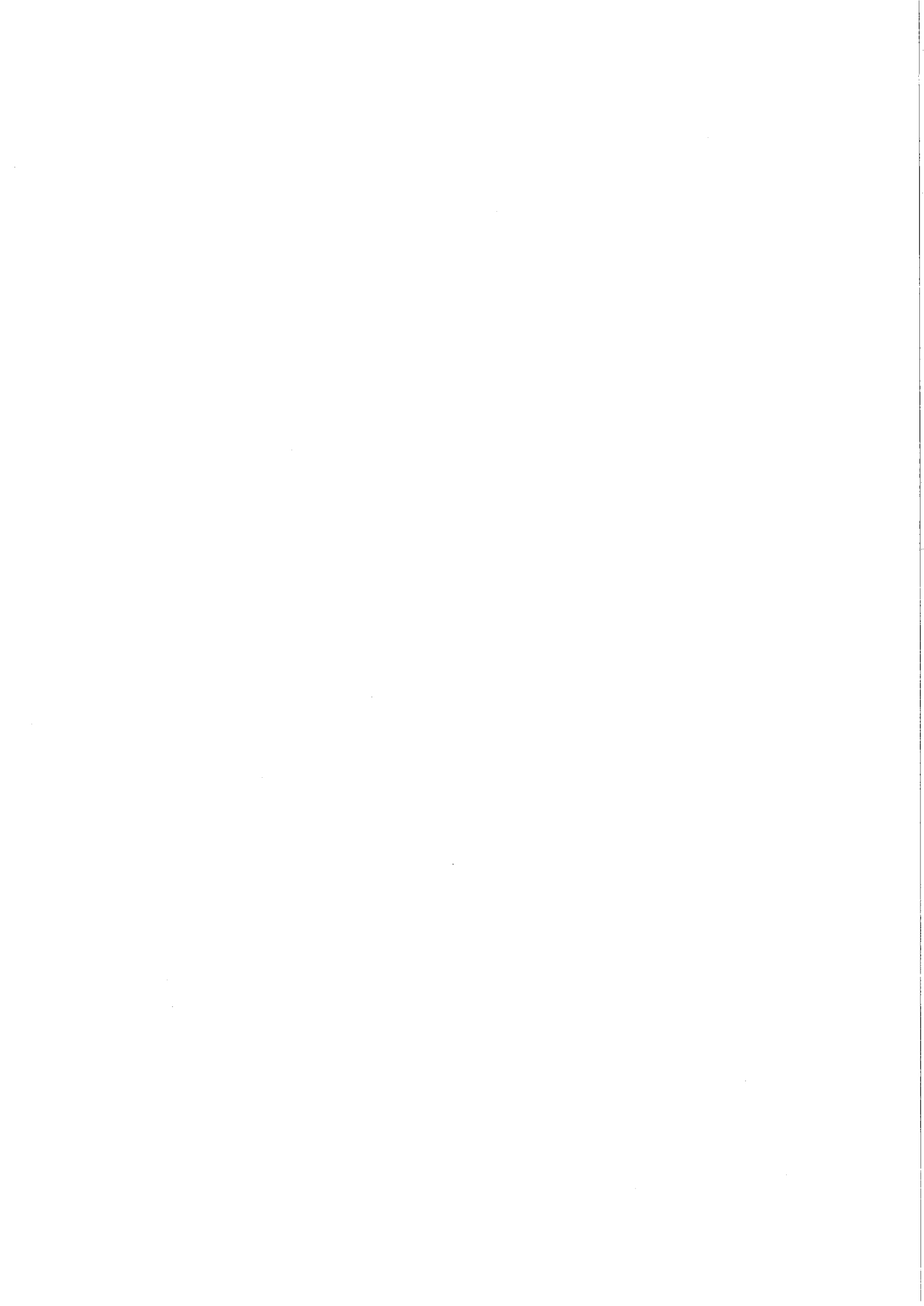
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Contents

| | |
|---|----|
| Foreword | v |
| 1. Introduction | 1 |
| 2. Theoretical backdrop | 3 |
| 2.1 Reasons for trade and gains from trade | 3 |
| 2.2 Producer services and FDI | 6 |
| 2.3 Regional approaches to trade liberalisation | 7 |
| 2.4 Global production and marketing networks | 8 |
| 3. Patterns of trade in services | 10 |
| 4. The role of services – empirical evidence | 13 |
| 4.1 Financial services | 13 |
| - <i>Role in the economy</i> | 13 |
| - <i>Experience from reform</i> | 15 |
| 4.2 Telecommunications | 17 |
| Role in the economy | 18 |
| Experience from reform | 19 |
| 4.3 Transport | 21 |
| 4.4 Implementation issues for developing countries | 22 |
| 5. Implications for developing countries, summary and conclusions | 24 |
| References | 26 |



Foreword

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

Bergen, November 1999



1 Introduction

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

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

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

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

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

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

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

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

2 Theoretical backdrop

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

2.1 Reasons for trade and gains from trade

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

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

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

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

² Which to some extent explains why South African Breweries invests in Tanzania

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


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

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

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

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

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

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

⁴ The proliferation of Internet cafes in African cities indicates this.

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

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

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

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

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

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

2.2 Producer services and FDI

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

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

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

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

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

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

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

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

2.3 Regional approaches to trade liberalization

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

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

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

2.4 Global production and marketing networks

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

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

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

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

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

3 Patterns of trade in services

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

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

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

Source: IMF Balance of Payments Statistics 1997

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

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

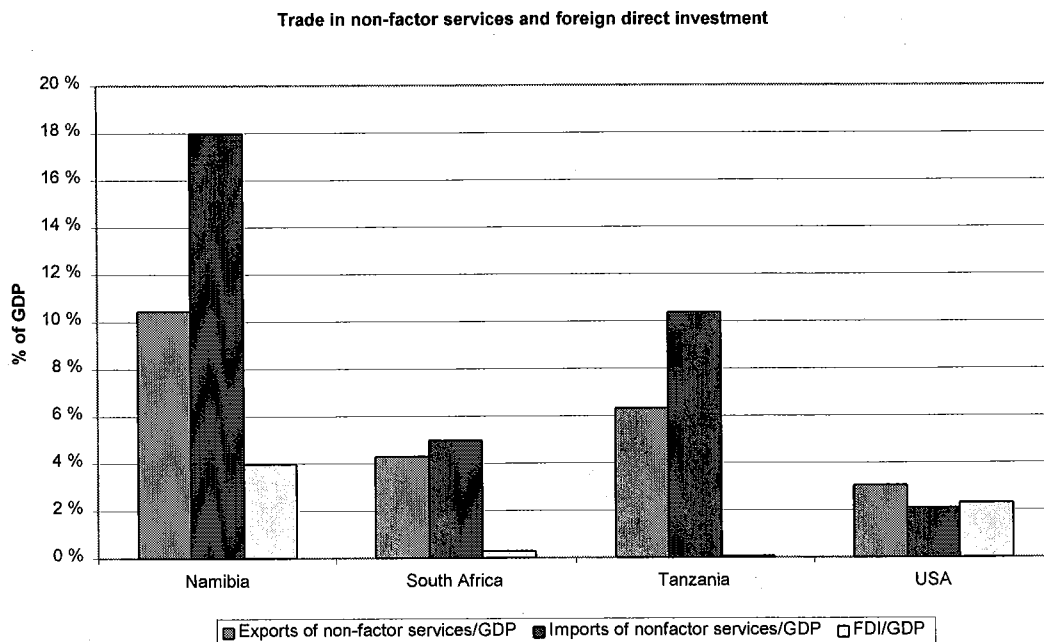
Source: Hodge (1998), Nepru (1998a)

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

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

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

Figure 1



Source: IMF (1998)

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

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

4 The role of services – empirical evidence

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

4.1 Financial services

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

Role in the economy

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

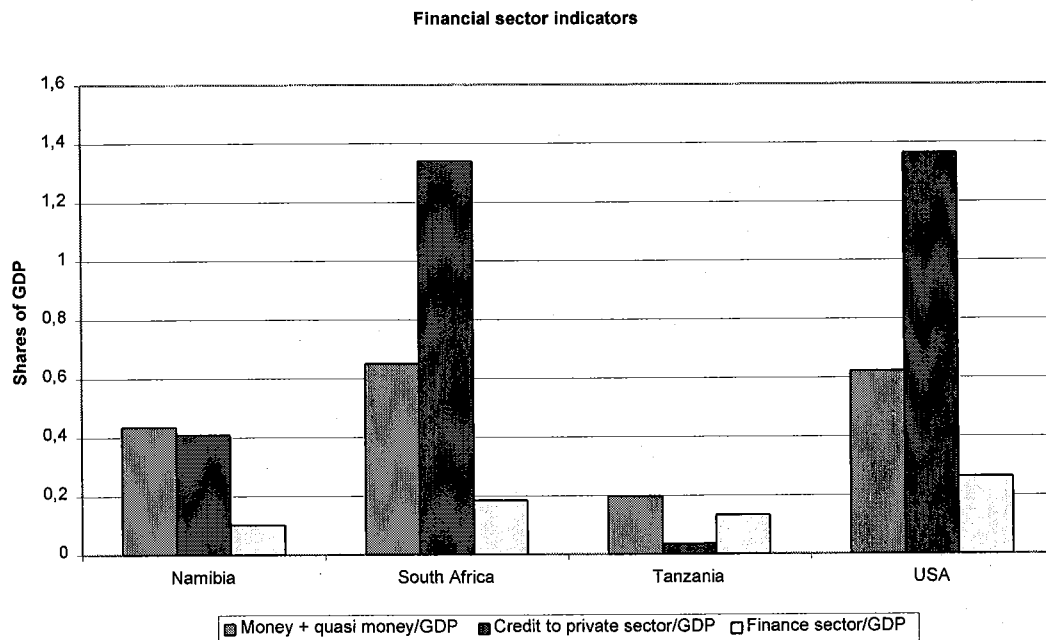
Well-functioning financial systems do a very good job of selecting the most productive recipients for [capital] resources. In contrast, poorly functioning financial systems often allocate capital in low-productivity investments. Selecting projects is only the first stage. The financial system must continue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

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

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

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

Figure 2



Source: IMF (1998)

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

