

Trade and foreign direct investment. A global outlook

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It is generally considered that the level of internationalisation in the services sector is very low. Unlike the manufacturing sector which regularly operates in global markets, most tertiary activities have until fairly recently had largely national or even local or regional markets. However, this is only half the story.



The growing importance of service activities in the internationalisation of our economies can be seen in the evolution of the indicators that measure their interest in foreign activity. However the nature of many services and the way they are provided mean that physical proximity and more or less continuous interaction between suppliers and users are essential. The criteria governing international trade in services are therefore very different from those applying to the trade in goods. Their statistical recording requires the use of appropriate instruments, which often differ greatly from those used to quantify the volume of international transactions in goods. This can be seen in the evolution of both trade in services and foreign direct investment.

Conceptualisation and statistical basis of international service transactions

One significant response of the international community to the progressive globalisation of the trade in services was the creation of the **World Trade Organisation** (WTO) on 1 January 1995. The WTO offers a common institutional framework for the development of commercial relations in its member countries.

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One of the main agreements reached by the World Trade Organisation was the **General Agreement on the Trade of Services** (GATS). GATS established an initial set of regulations and disciplines to govern the application of commercial measures to services for WTO countries.

GATS basically entails: a series of general objectives,¹ a set of specific commitments,² and several annexes.

Commercial negotiations require appropriate statistics, both for negotiating the specific commitments associated with transactions, and afterwards, to oversee their compliance with the conditions established in the trade or their modification, also negotiated.

In most cases, the development of statistics on the trade in services has been trailing behind the reality of the market. To resolve these deficits and deficiencies in statistics on the international trade in services, GATS has undertaken several initiatives. The two most important to date have been:

- ▶ The definition of the modes of *supply of services*.
- ▶ The drawing up of the **Service Sector Classification List** (known as document GNS/W/120).

In 1991, the secretary of **GATT** (General Agreement on Tariffs and Trade) drew up a note which established a classification for the service sectors, known as the Service Sector Classification List, in Document GNS/W/120.⁴ This document contains a list designed to facilitate trade negotiations rather than their statistical classification. However, by contributing to a clear definition of every service subsector, each subsector was made to correspond to a code in the **United Nation's Central Product Classification** (CPC).

Finally one further step forward was made in the normalisation of statistics on the international trade in services and its influence. This was the preparation, in 2002, of the *Manual on Statistics of International Trade in Services*, sponsored by the **United Nations (UN)**, the **Commission of the European Communities (CEC)**, the **International Monetary Fund (IMF)**, the **Organisation for Economic Cooperation and Development (OECD)** and the World Trade Organisation (WTO).

The Manual says the following in its introduction: «It is an important first step in addressing a growing demand from Governments, business and analysts for more relevant, detailed and internationally comparable statistics on such trade. A special emphasis is given to the statistical information needs of international trade negotiations and agreements.»

The *Manual on Statistics of International Trade in Services* «is a first step in addressing a growing demand for more relevant, detailed and internationally comparable statistics on such trade».

As a framework, the *Manual* has two essential components for describing transactions in the international trade in services:

- ▶ Transactions between residents and non-residents.
- ▶ Trade in services through the operations of foreign affiliates.

The statistical framework of the Manual with respect to transactions between residents and non-residents is based on the fifth edition of the IMF's *Balance of Payments Manual* (BPM5). BPM5 presents the conceptual framework for balance of payments statistics. This accounting document provides a systematic summary of a specific period of the transactions between residents of one country and residents of the rest of the world.

Transactions recorded in the balance of payments comprise trade in goods, services, income and current transfers and credits and obligations with the rest of the world.

BPM5 statistics are arranged in a logical structure to facilitate their use and adaptation for many purposes, including, as the *Manual* itself states: «policy formulation, analytical studies, projections, bilateral comparisons of particular

components or total transactions, and regional or global aggregations».

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BPM5 shares its conceptual framework with the United Nations **System of National Accounts, 1993 (SNA93)**. SNA93 presents an account with the rest of the world (external transactions account), containing an account of external transactions in goods and services, in which a separate record is kept of trade in goods and trade in services.

The Manual on Statistics of International Trade in Services also proposes an Extended Balance of Payments Services Classification (EBOPS), which is a very detailed subsystem of the BPM5 services classification,⁵ to improve the precision of statistics in this area of the international trade in services.⁶

Services firms are increasingly setting up foreign affiliates to provide service to foreign customers who demand a more frequent and intensive interaction between supplier and consumer.

Under the GATS system, sales made in a country by foreign affiliates are covered by the expression «international trade in services». Nevertheless, these foreign affiliates are classed as resident in the host country. Sales made within that country are not recorded in the balance of payments account, which only includes transactions between residents and non-residents. Statistics on the trade of foreign affiliates were designed to acquire this kind of information.⁷

These statistics measure the commercial presence abroad of service suppliers through affiliates in external markets, and are therefore closely linked to statistics on foreign direct investment.

The idea is to be able to brake down the variables of trade in services on the basis of producer activity (or of products made and sold). However, for some products, some variables in the trade of foreign affiliates (including value added and employment) cannot be determined from the statistics currently available. In this respect, the Manual on Statistics of International Trade in Services recommends that variables in the trade in services of foreign affiliates should be classified by activity, using the categories of the **International Standard Industrial Classification of All Economic Activities**, 3rd meeting (ISIC) (148).⁸

The *Manual on Statistics of International Trade in Services* recommends that variables in the trade in services of foreign affiliates should be classified by activity.

Statistics on the trade in services of foreign affiliates fall within the general framework of SNA93 and also comply with the conventions of BPM5.⁹ SNA93 defines a direct investment company as «an incorporated enterprise in which a foreign investor owns 10 % or more of the ordinary shares or voting power (for an incorporated enterprise) or equivalent ownership (for an unincorporated enterprise)».¹⁰

Trade in services

Global outlook

In 2005, international trade in services represented around one fifth of all global trade in goods and services.

This proportion undoubtedly contrasts with the economic weight of tertiary activities (which contribute over two thirds of the value added generated in the global economy). These are the figures that are usually quoted when considering

that services activities in general have little interest in international markets.

However some evidence seems to cast doubt on this statement. Recently, services have been the component of international trade to show most dynamism. In fact, in the 1997-2005 period, growth in international trade in services was 35.7 %, beating international growth in goods (34.9 %).

As well as the (growing) weight of the sector, the impact of technological advances (particularly IT and communications) has given a major boost to the international trade in services. As a result, some services, particularly those fully or partly based on the transmission of information content, can now be traded internationally. And as we have already seen, many services have become essential, as intermediary input, for the production of most goods and even of services themselves.

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In recent times, there have also been significant changes in the territorial and sectorial structure of international trade.

The international trade in services is heavily concentrated in a specific group of countries and economic areas. In 2005, slightly more than three quarters of this trade was concentrated in fifteen major territories. Of all the economic areas, it is the EU-15 which has the largest global share of the services trade: 25.8 % of the total, followed by the USA with 20.2 %, with Japan a long way behind at 6.8 %.¹¹

Of all the economic areas, it is the EU-15 that has the largest global share of the services trade, followed by the USA and Japan a long way behind.

This percentage went up in the 1997-2005 period in these first two economic areas: in the

EU-15 from 24 % to 25.8 %, and in the USA from 19.6 % to 20.2 %, while Japan's share fell by 9 % to 6.8 %.¹²

International trade in services between the EU-15 and the rest of the world advanced by 39.6 % during the same period. At this stage, the EU-15 recorded some large surpluses in its trade in services, particularly from 1999 on. From 1997 to 2005, the surplus increased by 56 %, while the surplus of the USA in the same period fell by 83.6 %. But by 2005, the EU-15's surplus in the global trade in services was still 34.9 % less than that of the US economy.

The USA is by a long way the main services trade partner of the EU-15. In 2005, 32.5 % of total service exports from the EU-15 had this country as their destination, while it accounted for 32.3 % of their imports.¹³

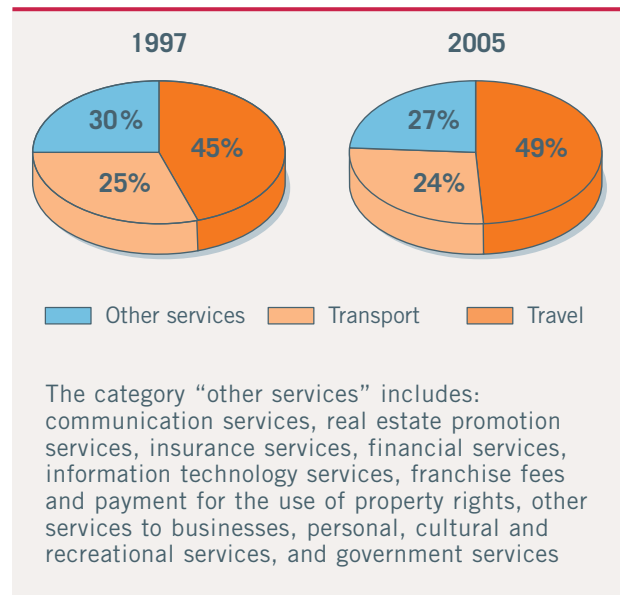
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In the period being considered, the service categories in which the volume of international trade grew most were information technology services,¹⁴ financial and insurance services, and other business services, to the relative detriment of transport and travel (Graph 1).

Some data on Catalonia

These global trends have also been confirmed in Catalonia. According to data produced by the input-output tables for Catalonia for the years 1987 and 2005, services represented a minor part of the total export figure, as can be seen in Table 1. In 1987, these services amounted to 18.7 % of the total export figures (a percentage very much below the proportion of gross value added to the Catalan economy represented by tertiary activities: 52.7 %). However, this percentage saw a significant increase in the later period: in 2005, the services' share of exports had increased to 27.3 % (while in the same year

Graph 1. Evolution of international trade in services (in %)



Source: IMF. *World Economic Outlook*. 2008.

▲ Travel is the first sector in the international trade in services

the proportion of the sector as regards total value added reached 67.4 %). In comparison, industry, which in 1987 represented 38.9 % of the value added of the Catalan economy, concentrating 84.7 % of its total exports. In spite of this, these proportions declined in 2005: the value added contributed by industrial activities was 21.3 %, and exports of industrial goods accounted for 71.8 % of the total.

In Catalonia, in the period 1987 to 2005, production services doubled their weight in relation to total exports.

Among tertiary activities, production services¹⁵ have shown the greatest tendency for foreign activity: these rose from 13.2 % of exports in 1987 to 26.0 % in 2005. Conversely, other services have only residual participation in outgoing trade.

Table 1. Percentage distribution of GAV (Gross Value Added) and the exports of the major sectors of the Catalan economy. 1987 and 2005

	1987		2005	
	GVA	Exports	GVA	Exports
Agricultural sector	2.47	1.70	1.20	0.95
Industry	38.85	84.65	21.26	71.77
Construction	5.90	0.00	10.17	0.00
Production services	34.59	13.21	44.39	26.00
Other services	18.20	0.45	22.99	1.28
TOTAL	100.00	100.00	100.00	100.00

Source: Own figures based on data from Idescat, Input-Output tables on Catalonia, 1987 and 2005

Table 2. Percentage of exports compared with the total output of the major sectors of the Catalan economy. 1987 and 2005

% of exports compared with total output

	1987	2005
Agricultural sector	8.92	11.06
Industry	35.65	39.49
Construction	0.00	0.00
Production services	11.75	19.06
Other services	0.88	2.33
TOTAL	22.76	24.00

Source: Own figures based on data from Idescat, Input-Output tables on Catalonia, 1987 and 2005

Table 2 lets us see that in the period considered, services activities were substantially increasing their part of the total output in exports: in the case of production services, from 11.8 % to 19.1 %, and in other services, from 0.9 % to 2.3 %.

The increase in the quota of exports in the total industrial output also grew, but in a more moderate proportion, from 35.7 % to 39.5 %.

Foreign direct investment in services activities

Global outlook

The structure of foreign direct investment (FDI) has also changed in recent decades in favour of services.¹⁶ At the start of the nineteen-seventies,

this sector included a quarter of the accumulated world volume of FDI. In 1990, the proportion was around 49 % and by 2003 the percentage had risen to 60 %.¹⁷ In the 1970-2003 period, the manufacturing sector's percentage in the accumulated world volume of FDI had fallen from 42 % to 34 % and in the case of the primary sector, from 9 % to 6 %.

The main way of internationalising services is by their permanent establishment in the target country, with cross-border trade having less significance.

These results provide evidence that the pattern of internationalisation of the services sector differs from that of the goods production sectors. In the former, the main channel is the establishment of a permanent commercial presence in the country where the services are to be provided, while as we have already seen, cross-border trade is relatively much less significant (in relative terms). The reasons for this pattern of internationalisation are basically linked to the way that many services are provided (see above), requiring interaction and therefore physical proximity between service users and providers.

The composition of FDI in the services sector is also changing. Until recently, investment was concentrated in trade and financial services. In 2004, these still absorbed 47 % of the accumulated total volume of FDI inputs in the services sector (in comparison with 65 % in 1990). However, in the period between these two years, the telecommunications sector, the electricity, gas and water sector and the business services sector went on to occupy a much higher position in FDI flows.¹⁸ In the latter sector, FDI inputs doubled its presence (rising from 13 % of the total in 1990 to 26 % in 2004).

These changes are due not only to the increased weight of services in the economy as a whole and the progressive internationalisation of many of these activities (particularly through having a per-

manent commercial base abroad), but also to modification of the pattern of internationalisation.

Foreign direct investment in the services sector had traditionally been made with a view to penetrating foreign markets, and companies engaged in it to support or complement their production abroad or the commercialisation of their products. FDI was concentrated in financial or insurance activities and transport.

Although this is still the pattern of FDI in the services sector, there are clear signs that major changes are in the offing. Recently, service providers have been choosing to invest more abroad. This is not just to guarantee (financial or commercial) fluency in transactions, usually in manufacturing, but also and increasingly to supply new markets for their services and to consolidate their competitive advantage. These providers are in most cases building on or consolidating a brand or representation in the international scenario.¹⁹

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The diversification of changes in the internationalisation of services activities is another sign of the change in this pattern. Here, apart from FDI, three new types of sector globalisation are starting to be seen: cross-border mergers and acquisitions, agreements which do not anticipate any kind of shareholder participation²⁰, and internationally integrated production systems.²¹

Data on Catalonia

Table 3a shows the percentual distribution of foreign direct investment in Catalonia broken

down into the main destination economic sectors. It can be seen that in the two periods considered, 1993-2000 and 2001-2008, the majority of these direct investment flows went to the tertiary sectors: 53.0 % and 59.4 % respectively.²² In these two periods, the proportion of foreign direct investment in the industrial sector went down from 42.3 % (1993-2000) to 35.6 % (2001-2008).

Table 3b shows that by destination sector, the evolution of Catalan investment abroad behaved in a very similar way to the previous table. However, in this case, the relative weight of investment in the services sector declined,

particularly due to the reduction of the percentage assigned to the production sector, which fell from 55.2 % of the total to 49.2 % between the two periods.

Conclusions

Until the start of the present decade, the recording of commercial flows and direct investment flows in services was precarious to say the least. The lack of appropriate conceptualisation of international transactions in the tertiary sector, and of any appropriate statistical

Table 3a. Percentage distribution of foreign direct investment made in Catalonia.

For major sectors of the economy

	1993-2000		2001-2008	
	thousand €	%	thousand €	%
Agricultural sector	88,636	0.63	67,537	0.37
Industry	5,996,565	42.33	6,575,402	35.60
Construction	572,320	4.04	849,098	4.60
Production services	6,621,166	46.74	9,187,759	49.74
Other services	887,960	6.27	1,792,419	9.70
TOTAL	14,166,649	100.00	18,472,216	100.00

Table 3b. Percentage distribution of Catalan foreign direct investment made abroad.

For major sectors of the economy

	1993-2000		2001-2008	
	thousand €	%	thousand €	%
Agricultural sector	2,527	0.02	47,240	0.13
Industry	6,005,974	40.05	15,713,049	42.55
Construction	146,532	0.98	1,002,915	2.72
Production services	8,274,264	55.18	18,163,037	49.18
Other services	565,543	3.77	2,004,649	5.43
TOTAL	14,994,840	100.00	36,930,890	100.00

Source: Own figures based on data from the Spanish Ministry of Industry, Tourism and Trade.

base for these exchanges, reinforced the belief that these service activities had little international importance. But this is only a half truth, which an improved theoretical and empirical consideration of the phenomenon is re-dimensioning to give a more accurate picture. The fact is that the internationalisation of services activities as a trend has been consolidating over the last two decades in most developed economies.

The lack of appropriate conceptualisation of international transactions in the tertiary sector, and of any appropriate statistical base for these exchanges, reinforced the belief that these service activities had little international importance.

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Notes

1. The main general objectives are the principle of the status of most-favoured nation and the principle of transparency.
2. Specific commitments as regards access to markets, national status and any other subject, are specified and consolidated in national lists resulting from negotiation.
3. For the definition of these modes of supply, see elsewhere in this issue of Paradigmes the article by Juan R. Cuadra-do-Roura.
4. GNS/W/120 includes twelve major categories of service: business services, communication services, construction and related engineering services, distribution services, educational services, environmental services, financial services, health-related and social services, tourism and travel-related services, recreational, cultural and sporting services, transport services and other services not included earlier.
5. BPM5 has eleven main standardised service categories. These eleven components match (with certain exceptions) the products included in GATS quoted above.
6. The necessary convergence of the classifications of industry and services products for comparative purposes has been achieved, in this case, with the correspondence between the EBOPS proposal and the Central Product Classification, Version 1.0 (CPC). The EBOPS is, in fact, a breakdown of the Joint OECD and Eurostat Trade in Services Classification (also closely linked to BPM5).
7. These statistics also include a set of other indicators that allow diverse aspects of the globalisation phenomenon to be evaluated. For this purpose, the OECD's *Handbook of Economic Globalisation Indicators* has recently been added.

8. ISIC is an international standard industrial classification of all economic activities. In this classification, a sector of activity is defined as the set of all production units engaged primarily in the same or similar kinds of productive economic activity. ISIC is a basic instrument designed to guarantee the international comparability of data in a wide range of economic and social statistics that include the variables of production, value added, employment and other economic figures.

9. They also tie in with the OECD's Benchmark Definition of Foreign Direct Investment (BD3), the CPC (version 1.0) and ISIC, rev.3 for classification of products and economic activities, and ILO standards for employment-related variables.

10. "Direct investment enterprises are those identified as *affiliates* (in which the foreign investor owns over 50 % of the capital), *associates* (less than 50 % is owned by the foreign investor) and *branches* (unincorporated, wholly or partially owned by the foreign investor." In addition, according to the SNA93 definition, enterprises under foreign control comprise affiliates and branches, but associates may or may not be included depending on a qualitative assessment of the foreign control.

11. The EU-15 is the main exporter of services (26.8 % of the total), but is also the main importer (24.8 %). It should be noted that over 50 % of international trade in services takes place between EU member states (intra-EU trade).

12. The evolution in the share of some emerging countries shows a notable growth, particularly in the case of China (from 2.5 % to 3.7%) and India (from 1 % to 1.4 %).

13. With respect to the USA, in 2005 the EU-15 had large surpluses in its main service categories: transport, travel and other services. Other important EU-15 partners in the trade in services were Switzerland, Japan and Norway (the EU-15 recorded large surpluses with all these countries). Conversely, trade in the services of this economic area with (mainland) China and India is much lower.

14. According to OECD data, trade in this kind of service has increased at an average annual rate of 17 %. There has also been considerable growth in the trading surplus in real estate and public works services and also government services. On the other hand, in communication services, personal, cultural and recreational services, and franchise fees and payment for the use of property rights, evolution has been negative throughout the 1997-2005 period. In the case of transport, except for air transport, all other types have presented significant deficits. The travel category was only in surplus in 1997, but went on to accumulate growing deficits.

15. Production services are services where a fairly high proportion of their provisions form part of the intermediary inputs in most sectors of the economy. According to Eurostat, production services consist of commercial services, electricity, gas and water distribution services, transport and communications services, financial and insurance services and business services.

16. See: UNCTAD: *World Investment Report 2004*, which significantly bears the title *The Shift Towards Services*.

17. In 2002 this percentage represented a volume of 4 billion dollars.

18. Between 1990 and 2004, the accumulated volume of FDI in the electricity, gas and water production and distribution sector multiplied by 14, in telecommunications, transport and travel-related services by 16, and in the business services sector by 9.

19. The strong increase in FDI in the business services sector over the last decade responds to this new internationalisation pattern.

20. For example, franchises, management contracts or agreements for cooperation. This type of agreement is highly appropriate for many services activities, whose competitive advantages are based on soft technologies, and particularly on intangible knowledge-based assets. The transfer of this knowledge (often codifiable) and these skills can be perfectly well supported by agreements which do not require shareholder participation.

21. These forms of investment are often found in hotel and restaurant activities, the retail trade, vehicle rental and many business service activities (audit, legal and other professional services).

22. In the services sector, the development of internationally integrated production systems is still in its infancy. In spite of the growth and progressive predominance of FDI in the services sector, these activities have a much lower rate of transnationalisation than in manufacturing activities. However, there are already indications that the international production of services is evolving, in this respect, in a very similar direction to the international production of goods.

In these two periods, most foreign direct investment in services in Catalonia occurred in the production services subsector: 46.7 % during the 1993-2000 period, and 49.7 % during 2001-2008.