

A stylized world map in shades of blue and white, centered on the Pacific Ocean, serving as a background for the text.

ADBI/ARTNeT

Reforming services for inclusive and sustainable
development of Asia and the Pacific

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**“The Importance of Measuring Mode 3
Services Trade; Some Case Studies from
Australian Business Experience”**

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Defining Services

- Given the conceptual complexity, services tend to be defined negatively ie all economic activity which is not agriculture, forestry, fisheries, mining or manufacturing.
- More positive and insightful definitions focus on intangibility; temporary ownership/access by the customer and on IP content
- Elements of all three are mirrored in the official definition in SNA 2008 which includes
 - “change effecting” services (which apply to goods or people) and “margin” services (which apply to goods or services), both of which can not be traded separately from their production ie they are rendered & consumed simultaneously and
 - “knowledge capturing” services over which ownership rights can be established, enabling them to be used repeatedly and traded separately from their production

Measuring Services



- There has been under investment in devising appropriate methodologies for the collection of national services statistics; in practice, services have been measured as a residual, with the result that the sector lacks a good statistical data base
- The usual excuse given relates to the intangibility of services and the fact that services can change in nature and quality quite quickly, especially with constant improvements in technology. In the last decade or so, these factors have been recognised as potential signals of innovation, hence perhaps justifying further investment in the statistical data base for services
- This presentation focuses on measurement specifically of *trade* in services; in Australia trade statistics are collected only for relatively aggregated sets of services activities; there are 7000 disaggregated categories for goods but only 70 for services

Defining & Measuring International Trade in Services



- Mode 1 is the only mode of delivery that most collections cover; ABS measures these via a sample survey of services providers that declare themselves exporters; if the service is provided direct to the client the ABS is likely to pick it up; if it is delivered (& invoiced for) via a local offshore office, it will become buried in “services between affiliated enterprises”
- Mode 2 tends to be ignored; but the ABS makes special efforts to produce collections on education services and tourism, these being Australia’s top services exports
- Mode 3 is not measured in Australia and in any case, if it was, it could not be classified or described as “trade”
- Mode 4 would not necessarily be picked up unless so declared by the exporter
- All modes of trade in services are under reported.

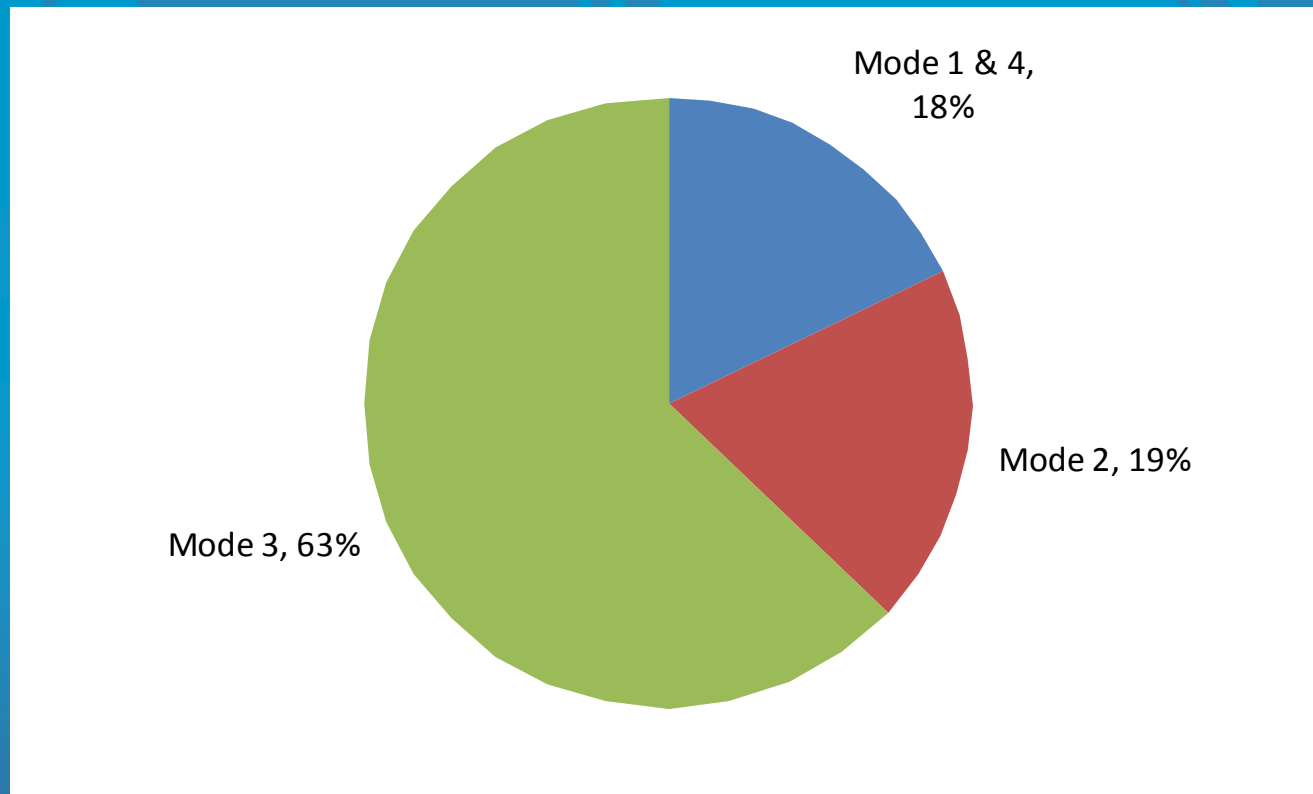
Mode 3



- Mode 3 breaks the traditional pre-GATS definitional convention as to what constitutes “trade”, the transactions involved being unlike conventional “imports” or “exports” which are transactions between residents and non residents
- The concept of Mode 3 pushes awkwardly up against the statistical measurement conventions of the BoP and the SNA and a result in most countries goes completely unmeasured , unlike Modes 1, 2 and 4 which are merely imperfectly measured
- MSITS 02 recommended methodologies for measurement of trade in services, specifically arguing that Mode 3 should be measured because it was subject to international disciplines in the WTO; few governments have made even partial progress towards implementation
- This matters because Mode 3 appears to account for more than 1/2 world trade in services

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- This tends to be dismissed on the basis that FDI statistics are an acceptable proxy; a flaw in this approach is that services are now coming to dominate the FDI statistics as well. World Investment Report 2004 shows services account for 60 % of the global stock of FDI
 - MSITS 2010 draws attention to the disconnect between data showing that services industries are the largest recipients of global outflows of FDI and yet comprise only 1/5 of world trade; the data gaps on the “trade” side are prejudicing the international research agenda
 - The business case studies presented demonstrate that even when supplemented by FDI data, the traditional BoP data are not currently up to the task of capturing global trends in international business
 - Recent UNCTAD work shows Mode 3 is at least as high for OECD countries as the value of exports recorded in the BoP. Work by Magdeleine & Maurer suggests Mode 3 accounts for 55-60% of total services trade.

Australian supply of international services by mode, 2002-03



Data source: WTO calculations reported in Magdeleine, J and Maurer, A, 2008,

ABS Pilot Survey on Mode 3

- The ABS conducted an experimental survey of outward foreign affiliates trade in 2003, combining the frames for the Survey on International Investment & the Survey on International Trade. Only 100 % Australian owned companies were covered. Confidentiality issues impacted on the survey results released in 2005
- Nevertheless, the outcome was clear
- The official Australian data on services exports were shown to be measuring less than 1/3 Australia's actual offshore business ("exports") in services
- The underestimation was especially significant for financial services including insurance and for a range of professional services including legal services

Survey results

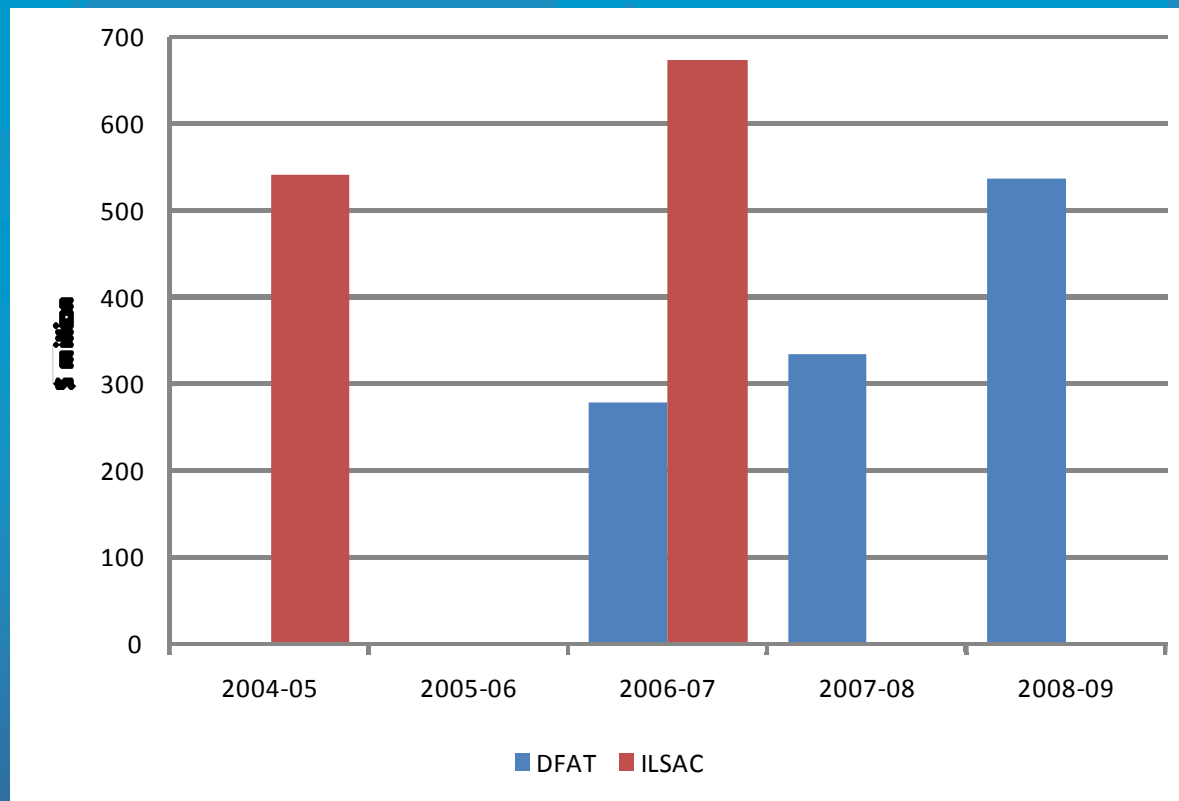
- 4,000 100 % owned firms employing over 300,000 staff, generating \$142 b in sales revenue of which just under 1/2 was in services (1/2 of that was in Americas, 1/3 in Asia and 1/6 in Europe)
- Foreign affiliates were primarily established to service the markets where they were domiciled; 90% of sales were in the host economy
- Despite persistent and voluble business support for further work, the pilot survey has never been repeated
- In last 5 years or so, a number of industry-led sectoral surveys have been undertaken to try to fill the evident and persistent lacunae in the official data

Legal Services

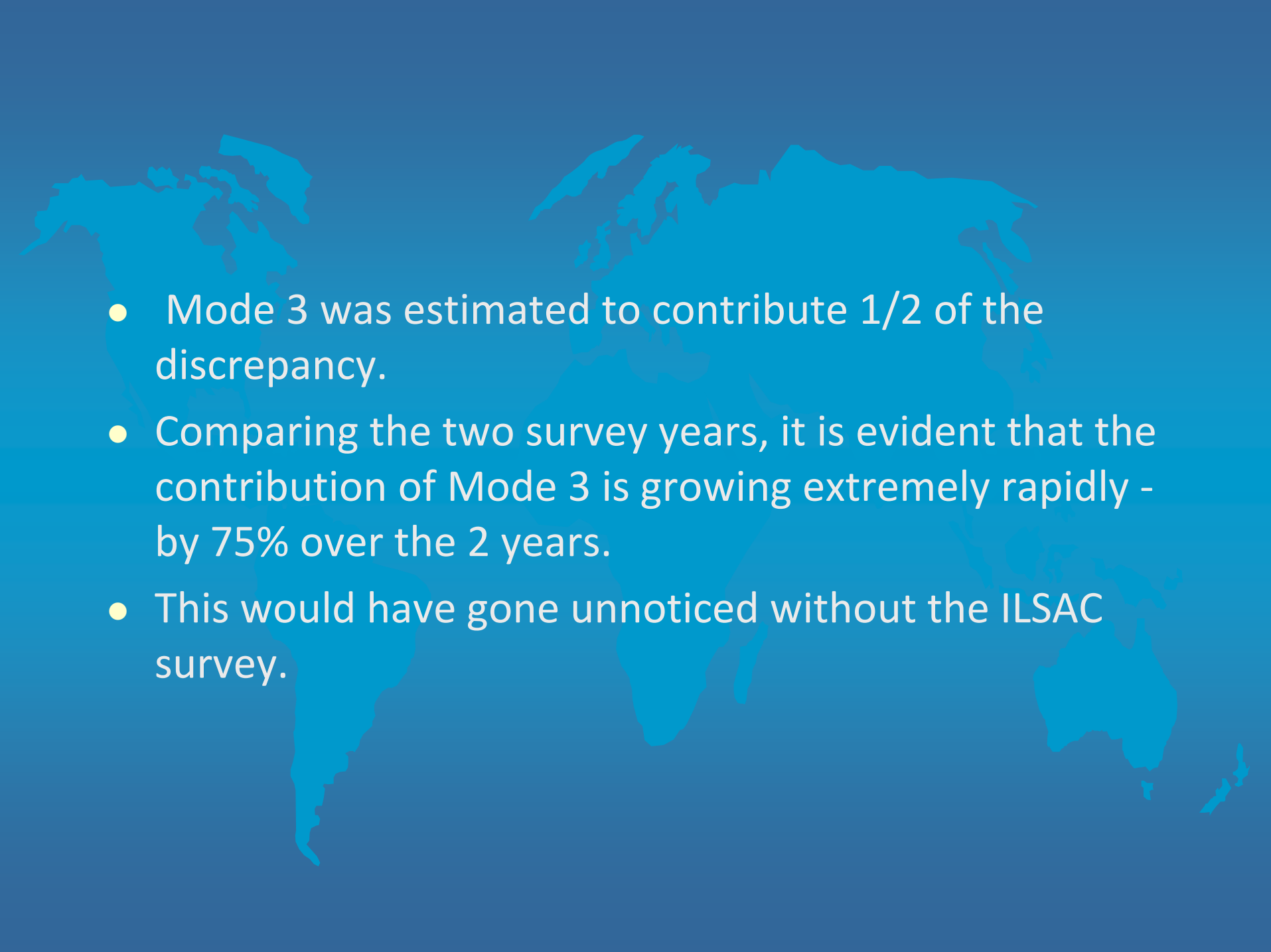



- Ground breaking survey work undertaken by Australia's International Legal Services Advisory Council (ILSAC- for which the Attorney General's Department provides the Secretariat) in conjunction with Austrade, Law Council and 8 leading law firms
- Project aimed to measure Mode 3, including for specific subsets of legal services and geographic markets
- Problematically, definitions used departed from convention because the survey aimed also to measure legal services provided by Australian resident legal practices to Australian companies where the work originated from an overseas project
- Despite its flaws, the survey elicited extremely interesting data allowing for useful trade related analysis
- Two surveys were undertaken, in 2004-05 and 2006-07, the results of the latter becoming available Feb 2009
- Both sets of results confirm there is major underestimation on legal services exports, including as a result of failure to measure Mode 3

Total combined “export and cross-border income” was reported at 142% higher than the official ABS figure.



Legal services exports - Comparison of ABS/DFAT export data and ILSAC data on exports and cross-border income

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- Mode 3 was estimated to contribute 1/2 of the discrepancy.
 - Comparing the two survey years, it is evident that the contribution of Mode 3 is growing extremely rapidly - by 75% over the 2 years.
 - This would have gone unnoticed without the ILSAC survey.

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- Even the estimate of conventional exports was 41% higher than the ABS
 - This seems to be due to inadequacies in the ABS survey frame; ABS adjusted its frame in line with ILSAC and in 2008-09, Australia's legal services exports jumped 60% (whereas most legal firms report 2008-09 as a difficult year)

The survey elicited a wealth of other findings



FINDING

All international work is very concentrated (10 firms accounted for 80% of earnings in 2006-7)

FINDING

Although North America is still the overwhelmingly largest export market, it is now chiefly serviced via Modes 1 and 4; commercial presence has shifted to Asia; there are no longer any Australian legal firms with offices in the US

FINDING

Taking Mode 3 into account, the Asian market for Australian legal services has grown more than twice as fast as the rest of the world

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FINDING

Mode 3 is very important for delivery into China
PRC

FINDING

Other important Mode 3 markets are New Zealand, Papua New Guinea, Singapore and United Kingdom

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FINDING

The geographic source of income into offshore offices is diverse; contrary to the findings of the ABS pilot survey, firms establish a presence in a convenient location to service the surrounding region.

Income diversity was greatest for offices established in Singapore where only 62% of income derives from sales within Singapore. More than 10% is South Asia.



FINDING

Mode 1 is used for Corporate Legal Services, IP, ICT, Litigation and Banking & Finance

Mode 3 delivery is twice as important for Banking & Finance

Fly in-Fly out is used for IP, IT, Telecoms, Mining and Resources

These are immensely powerful findings from a trade negotiating perspective and completely unavailable from the ABS data

Survey Importance

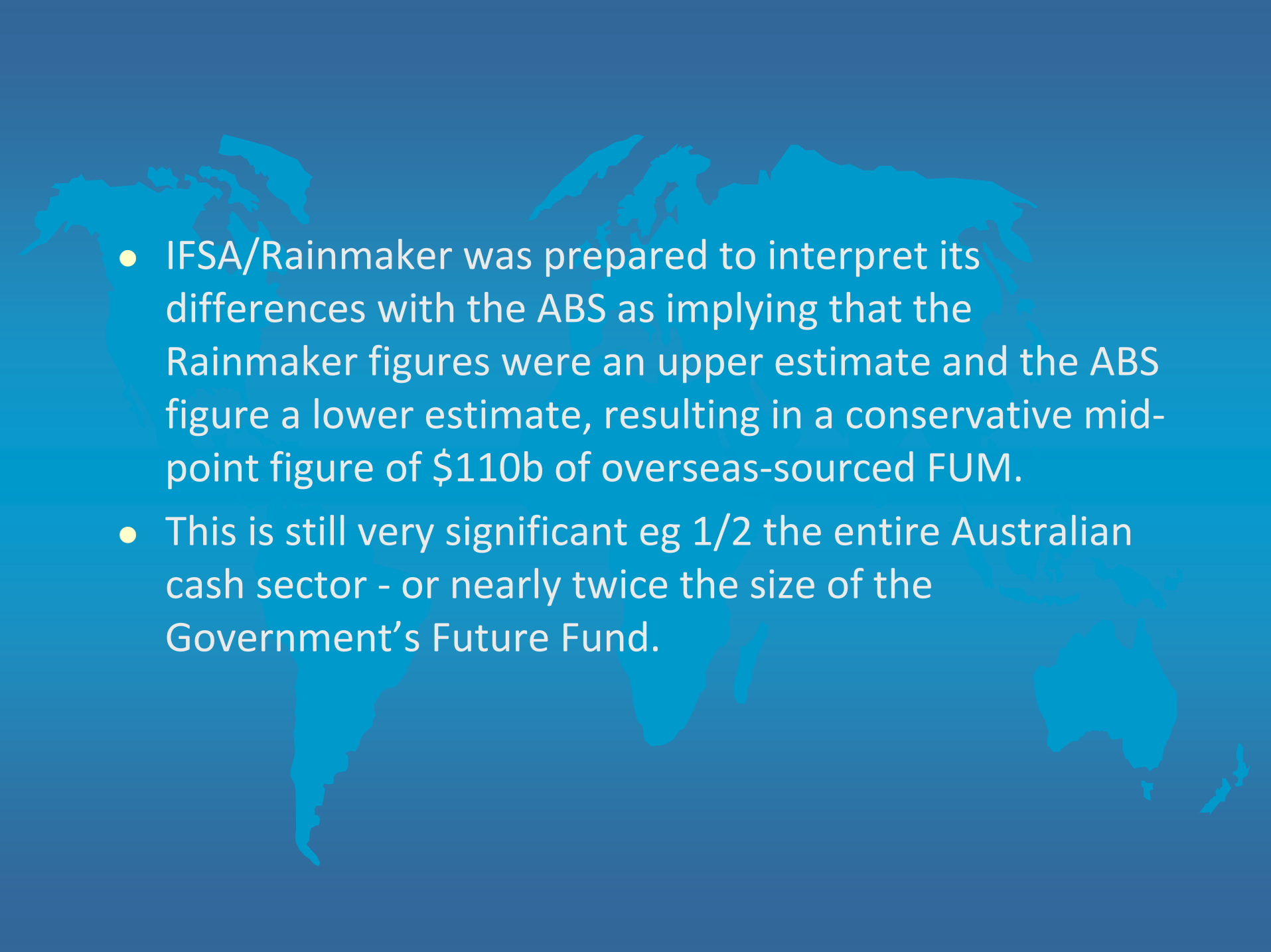
- valuable insights into the process of globalization of legal services
- helped the ABS correct gaps in the export frame and improve the conventional BoP data on legal services
- extends the available data on foreign affiliates' trade in services.
- enables a further trade research agenda which was inconceivable given the gaps in the official database. ILSAC is now identifying priority markets with respect to which it makes sense to devote negotiating resources
- elicited rich qualitative and anecdotal material on how legal services trade actually takes place and how it is classified, recorded and valued by firms. The survey's departure from the constraints of international statistical standards is as much an asset as an imperfection.
- allows the major players in the legal services sector to get together to take stock and to consider the policy settings which might promote greater innovation, efficiency and competitiveness going forward.

Financial Services (Funds Management)

- Despite the enthusiasm for policies to continue to grow Australia as an international financial centre, little is actually known about the extent to which Australia already exports its investment funds management expertise
- How increased globalisation of the financial services sector can best be captured in the trade statistics is a relatively complex and unresolved matter
- To help fill the information gaps, the Investment and Financial Services Association (IFSA) commissioned a private sector study by Rainmaker Information Pty Ltd.
- In funds management, in order to determine the value of exports, you first have to estimate the value of overseas sourced funds under management (FUM); every transaction relevant to those funds attracts a financial service fee from non-residents, those fees constituting exports.

Estimating FUM

- At end Dec 2007, the ABS estimate for overseas sourced FUM was \$58 b; for the same period IFSA/Rainmaker estimated FUM at \$161b or 178% higher. The private sector survey also found that overseas sourced FUM was growing 1/3 faster than Australian-sourced FUM ie exports (non-resident clients) were growing faster than the domestic market
- IFSA/Rainmaker suggested that with a bit of effort, by 2017 talented Australian funds managers could be sourcing as much as \$740b from non-resident clients
- Despite close consultation processes, the IFSA/Rainmaker survey and the ABS survey were ultimately not comparable; unworried by this, IFSA concluded that the ABS definitions of financial asset classes, based on international statistical standards, were out of date and irrelevant to contemporary market realities eg “the ABS category of ‘equities and units in trust’ confuses underlying assets with the investment instrument used to package those asset holdings....” etc

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- IFSA/Rainmaker was prepared to interpret its differences with the ABS as implying that the Rainmaker figures were an upper estimate and the ABS figure a lower estimate, resulting in a conservative mid-point figure of \$110b of overseas-sourced FUM.
 - This is still very significant eg 1/2 the entire Australian cash sector - or nearly twice the size of the Government's Future Fund.

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- A world map is shown in the background, with the continent of Australia highlighted in a bright red color. The rest of the map is in a dark blue color. The map is centered on the Pacific Ocean, showing the Americas on the left and Asia and Australia on the right.
- The IFSA study found that more than 1/3 of Australia's funds managers are involved in export activity and that 1/2 of the leading managers are indigenous to Australia, with Australian-originated managers holding the top 4 places with 68% of the export market.
 - Putting this differently, the study found that as many as 1/2 of the Australian-based funds managers which are exporting are foreign affiliates of non resident firms - and inwards foreign affiliates have a 1/3 share of the export market.

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- Export business was found to be more than twice as concentrated as the overall funds management industry; while the 5 biggest managers of domestic funds do 30% of the business, the 5 biggest exporters, 1 of which is an inward foreign affiliate, attract 75% of the work.


Markets for Australian funds management expertise



- The private sector study obtained a detailed breakdown on geographic market destinations for funds management exports, showing that China, PRC now almost matches the US but that Australia was under-performing in India and the Middle East
- The study provided an export client breakdown showing the percentage of export transactions taking place with pension funds, mutual funds, sovereign funds, institutional managers, individuals and insurers
- None of this detailed level of information (essential for example for trade negotiation purposes as well as strategic business decision-making) is available from ABS collections

Financial Intermediation Services Indirectly Measured (FISIM)

- Based on the (under)estimates of FUM, the ABS then estimates exports of financial intermediation services.
- In 2008-09 the value of financial services exports were reported to have risen by more than 13% to \$1.2b, with a rise of export volumes of nearly 10%. In a period of global financial downturn, IFSA decided this figure needed some scrutiny.
- It turns out that explicit charges in fact fell 8.8% - in line with expectations during the crisis - but FISIM rose 32%. FISIM relates to the margins between interest paid and interest charged and has only recently been added to ABS calculations of exports, having been recently added by the IMF to the guidelines for BoP accounts. In periods of high risk of default, FISIM is likely to rise; when the risk of credit default is lower, FISIM exports may be expected to drop, with the counterintuitive outcome that total financial services exports might also suffer!

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- Having identified all these various problems, IFSA/Rainmaker concluded “the real problem is that the ABS survey in its current form distorts official perceptions for how important our industry actually is for Australia’s economy, with dire policy consequences”
 - That sentiment, unfortunately, is echoed right across Australia’s entire services sector

Other Services

- The paper refers to anecdotal business evidence suggestive of major problems in the ABS collections on a variety of professional and technical services particularly architecture, engineering, ICT, media and entertainment and services incidental to both agriculture and mining. There is good reason to suspect that the scale of Mode 3 exports of these services is similar to legal services and that the problems of the inadequacy of the frame for measuring Mode 1, 2 and 4 exports are also present
- Australia's services industries are globalising and it is a costly task for the ABS to keep its surveys up to date. But it has to be done. The evidence is compelling.
- Of Australia's top 100 companies, based on offshore revenues, 1/2 of these, according to EFIC data, are services firms; on average offshore revenue as a proportion of total revenue for these services firms was 42% (financial services were above the average with 58%).

Result

- Taking all this official, semi-official and private sector evidence into account, it does seem that around 2/3 of Australia's outbound services trade takes place via Mode 3.
- Adding the missing 63% of Australia's international supply of services to the ABS trade data would mean that services comprise, conservatively, around 39% of Australia's international supply of goods and services.

Conclusions and Implications

- It is important to measure Mode 3; governments need to devote resources to this purpose; FDI statistics are not a sufficient proxy
- The absence of measurement of Mode 3 has contributed to a very incomplete public understanding of the importance of international integration in services and its potential for growth
- Poor public understanding compromises the formulation of services sector policy and clouds business focus in exploiting growth opportunities
- Trade negotiations and other efforts to facilitate trade in services have been hindered by the poor statistical data base

- The official perception in Australia that services account for 20% of Australia's exports does not withstand scrutiny. The real figure, of the extent to which Australian services providers contribute to Australia's international business, is closer to 40 %
- This gap between perception and reality is a problem for Australia and a problem everywhere in the Asia-Pacific region
- With services everywhere accounting for more than 50% of GDP, the regions' future economic growth will be substantially determined by improvements in productivity and competitiveness in services
- But the services sector is not receiving the policy focus required