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***Financial and Banking Services Market***

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**TRADE IN SERVICES**

**Abstract**

Trade in services differs from trade in physical goods. This article highlights some effects of liberalization of trade in services, especially the effects of off-shoring. Many Western European companies settle new branches in Eastern European countries, and this process is known as «off-shoring». This is a new phenomenon discussed in the Western European press, particularly its effects on the labour market. But off-shoring does not only create unemployment in the country where branches were closed. Off-shoring can lead to adjusted wages in the off-shored-sector: after a decline of wages, they can rise again.

**Key words:**

High-skilled and low-skilled workers, liberalization, off-shoring, trade barriers, trade in services, wages.

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## 1. Introduction

Trade in services is a new phenomenon. Economic scientists were looking for an explanation of the international trade in complete goods. Due to recent improvements in the transportation and communication technology, the trade in services is currently increasing (see Table 1).

Table 1.

**Growth of commercial services exports by category and by region, 1990–2006** (Annual percentage change)

	Commercial services	Transportation services	Travel	Other commercial services
1990–1995	9	6	9	10
1995–2000	5	3	3	7
2000–2006	11	10	8	13

Source: The WTO, 2007.

What exactly is «trade in services»? I follow the definition of the World Trade Organization (WTO) and its «General Agreement on Trade in Services» (GATS). The WTO identifies four modes:

(1) «The supply of a service from the territory of one Member into the territory of any other Member». The supplier doesn't leave the home country. For example, an Indian software engineer stays in India and develops the software for a foreign company.

(2) «The supply of a service in the territory of one Member to the service consumer of any other Member» [of the WTO]. This is the classical tourism example. The tourists go to another country in order to consume leisure time services. The service providers stay in their home country and the tourists leave their home country.

(3) A commercial presence of a home country company in the territory of a foreign Country; i.e. a German company opens a new branch in the Ukraine.

(4) Service supply through presence of natural persons in the territory of any other country. The supplier leaves his home country in order to offer and

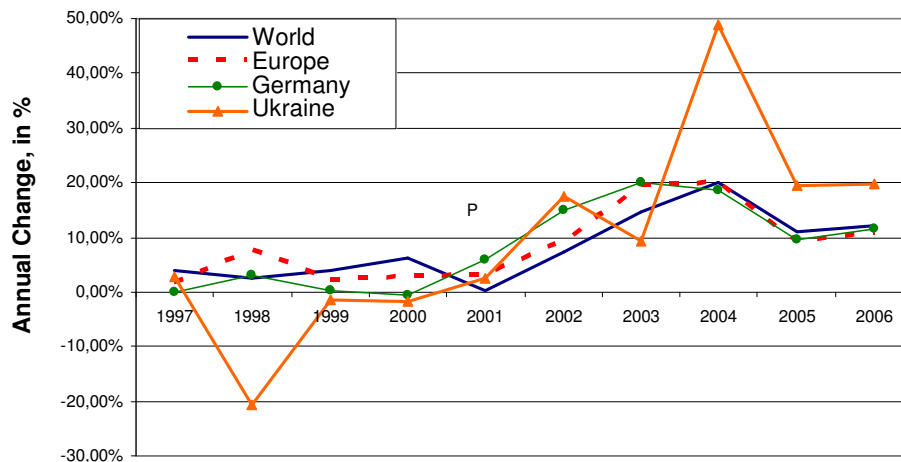
execute his service in a foreign country. The definition differs from migration because the services supplier stays in the foreign country only to perform the service and leaves it after fulfilment. Migration would mean a change in residence intended to be permanent.

Services are an important input factor for physical goods. Most of the trade theories examined trade in goods and not trade in input factors. There is a need for new models, which can explain trade in services and implying consequences. The importance of this phenomenon is shown in Figure 1. There is a rise of exports of trade in services worldwide, in Europe, Germany, and Ukraine.

Deardorff (2001) explains welfare effects caused by the liberalization of trade in services. He argues that many services are inputs for physical goods. The liberalization of trade in these input factors can reduce the real costs for any other producer of physical goods. The liberalization of the respective tariffs creates welfare effect for the consumers of this special good. However, services are inputs for many goods, e.g. transportation services. The liberalization in this sector reduces the real costs for all users of transportation services, so such a reduction in trade barriers has effects on other sectors and creates welfare effects for many consumers.

Figure 1.

#### Annual Rate of Growth in Exports of Commercial Services (1997–2006)



Source: The WTO, 2007.

## 2. Barriers to Trade in Services

In the previous Section, we discussed the effects of liberalization of the trade in services. Now we want to explain barriers for trade in services. We follow Banga (2005), who distinguishes four barriers:

1. Product movement provides, for example, no guarantees for property rights. E. g. software cannot be exported abroad, because exporters fear illegal adoptions by the people of foreign countries.

2. Restrictions on capital movements can constrain investments in the services sector, e.g. a company does not set up a new call centre in the foreign country.

3. Restrictions on human movement, which concern especially «modus 4». They reduce factor mobility and can increase trade in goods.

4. Restrictions for supplier subsidiaries, e.g. a services supplier cannot establish a new branch in the foreign market.

A cut in these barriers for trade in services creates welfare effects for the whole economy because services are an input for many physical goods, like those discussed in the previous Section. Now I want to regard their effects for the labour market.

## 3. Gains from Liberalization and the Labour Market

The liberalization of trade in services has welfare effects, as shown in Deardorff (2001). However, the reduction of barriers has different effects. One of these effects is discussed in Grossman and Rossi-Hansberg (2006). They assume that the production of a good needs special tasks. These tasks, maybe a service like software engineering, can be handled offshore in another country, for example for considerations of cost-savings. «A decline in the cost of task trade has effects much like factor-augmenting technological progress». Grossman and Rossi-Hansberg regard two industries with perfect competition. Both industries need high-skill und low-skill tasks. The firms produce two goods with constant returns to scale. But the industries differ in their factor intensities; this means one industry uses more low-skilled labour input than the other industry does. The productivity of tasks, which can be done easier offshore, is rising. The reduction in the costs for off-shoring has productivity effects. The costs of performing a set of low-skill tasks decline in both industries. The demand for low-skilled labour rises, and thus wages for low-skill tasks rise as well. This leverages the domestic labour market. Note that some tasks, especially low-skill

tasks cannot be settled offshore, hence the cost of performing low-skill tasks fall in both industries. Lower wages raise the demand for low-skilled labour in both industries, and the wages rise again. However, the adoption of this process is not time-invariant: unemployed low-skilled workers must reabsorb in the economy. Unemployed workers in the countries with low social protection must accept lower wages; they solve their labour supply with a cost-benefit-analysis. This is a problem in the countries with minimum wage laws, «strong» labour unions or other government regulations. Such structural «rigidities» can explain high unemployment rates in the Western European countries (Bernanke and Frank, 2007).

Grossman and Rossi-Hansberg (2006) distinguish between a decline in the cost of offshoring and a fall in the cost of migration. If the costs of migration decline, this will lead to the result of higher net income for the immigrants in the low-skill sector; but it does not change the productivity in this sector, the wages are equal. Thus, «there is no increase in the profitability and no pressure for domestic wages to change.»

There are similar effects for the off-shoring of high-skill tasks. The reduction in off-shore costs can be interpreted as a factor-augmenting technical process; this spurs the off-shoring of the high-skill task and generates gains for domestic high-skilled workers in the form of increasing wages.

#### **4. Enhancements for Off-Shoring**

On the one hand, better human capital endowment will result in an improvement for off-shoring, which is associated with foreign direct investments. Low skill does not mean «no skill». Many functions, which were off-shored, require education, e. g. in accounting, call-centres or other white-collar services, and employees must speak English. Barro and Sala-i-Martin (2004) showed the effects for the schooling-level and the economic growth: a higher level of schooling tends to a higher GDP growth rate.

Second, off-shoring brings improvements in the infrastructure, such as transport and communication technology. The establishment of call centres and other white-collar services prefer stable Internet and communication networks.

Third, falling corruption benefits the establishment of white-collar services, which will protect the parent company, like the insurance.

Fourth, the liberalisation of the services sector can raise trade in services and bring welfare effects to the nations involved in it.

Trade in services and especially off-shoring are not the evil thing that creates unemployment. It is a part of globalization; the politicians cannot stop it, but they can create an institutional framework to support the liberalization of trade in services and disburden the processes of adjustment, especially on the labour

market. For example, politicians actually claim: «Don't offshore this branch!» But why don't they offer alternatives (competition, labour mobility), so that the people in the home country and abroad benefit from off-shoring?

## **5. Conclusions**

The liberalization of trade in services generates welfare effects because different industries can benefit from these liberalizations in the form of reduced costs. However, people are afraid of their home companies going «off-shore», with foreign workers taking over their tasks and subsequently making the workers in the home country unneeded. Grossman and Rossi-Hansberg show: if the affected workers accept lower wages, the demand for low-skilled workers will rise, thus wages in this sector can rise again. Therefore, the home country and foreign country can benefit from «off-shoring» and trade in tasks. The last Section presented some facts in support of «off-shoring», so that home and foreign countries can benefit from the rising trade in services.

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