Interview with Mario Pezzini, Director of the OECD Development Centre and Special Advisor to the OECD Secretary-General on Development

Service Sector Key to Achieving Inclusive Growth in Emerging Asia

By *Japan SPOTLIGHT*

The Organisation for Economic Co-operation and Development (OECD), a multilateral forum promoting policies to improve the economic and social well-being of people around the world, is today expanding its links with Asia, a locomotive for global economic growth.

Its Development Centre is playing a pivotal role in these outreach activities, as a forum where countries of different levels of development come together to share their experiences on economic and social policies. It contributes expert analysis to the development policy debate and helps decision makers find policy solutions to stimulate growth and improve living conditions in developing and emerging economies. The Centre's Governing Board comprises 52 countries, of which 27 are OECD members and 25 partner countries from Africa, Asia and Latin America. The European Union also takes part in the work of the Governing Board.

As Asia pursues the goals of inclusive growth and income equality, the service sector is set to play a key role in promoting, especially in terms of structural reform and job creation. Mario Pezzini, director of the OECD Development Centre and an economics professor before joining the OECD, kindly responded to our questions below in writing via e-mail. In this interview, he provides insights with an overview of the sector and of the reforms needed to make the most of the existing potential.

(Interviewed on June 7, 2017)

Service Sector Overview

JS: What is the current condition of the service sector in Emerging Asia economies? What is the contribution of the service sector to economic development over time in Emerging Asia? Why is the service sector playing such significant roles in the growth of the region's economies?

Pezzini: When we talk about the service sector, what we are talking about is an array of subsectors, including financial intermediation, wholesale and retail trade, tourism, utilities, transport, storage and communication.

The service sector makes a direct contribution both to GDP and to creating jobs, and an indirect contribution by providing key inputs for other economic activities. Services are a key component of a country's overall investment climate and can have a significant impact on competitiveness and an economy's levels of investment and productivity. Services also play a crucial role in linking various production activities within and across national borders. They are one of the major sources of innovation in terms of new forms of organization or relationships with customers. Moreover, as companies increasingly focus on providing "solutions" or "experiences", rather than "products", the boundaries between services and other sectors, such as manufacturing, have become blurry. But the bottom line remains: expanding the service sector can be an important source of employment and growth. Services, particularly knowledge and information services, can also improve the efficiency and productivity of the overall economy.

Mario Pezzini, Director of the OECD Development Centre and Special Advisor to the OECD Secretary-General on Development

In Emerging Asia (Southeast Asia, China and India), the service sector plays an increasingly important role in economic development given its sizeable contribution to economic output, employment and trade, which continues to increase (as observed in the last 10 years).

On average, the service sector accounted for about 49% of the total production (GDP) of Emerging Asia economies in 2016 and sourced roughly 55% of the total employment in the region in 2015 (where data are available). These figures are modestly higher than the sector's economic and employment shares a decade earlier, that is, less than 45% of output in 2005 and about 48% of the jobs in 2006.

Moreover, based on World Bank data, Emerging Asia's services exports and imports rose to around 23.5% of GDP by the end of 2015 from 20.1% in 2010, while the average share of services trade in total trade has risen to about 20% in 2015, from less than 17% in 2010.

While rising, services' share of economic activity in Emerging Asia is still below what we observe in OECD countries as well as many emerging economies. In OECD countries, the service sector accounts for 75% of GDP, while in large emerging economies like Brazil it represents 71% of GDP and is the main job creator. In contrast, even in the largest economies in Emerging Asia, such as China, the service sector's contribution to GDP is still below these levels. This holds true particularly for those services in China that have the highest potential to help move the economy up the value chain, such as business-support services, telecommunications and financial services.

Structural Reform in Service Sector

JS: Would key structural policy reforms stimulate the growth of the service sector? How will the service sector be affected by structural reform? What is the main factor of structural reform that will help raise labor productivity in the service sector?

Pezzini: Stimulating the service sector (or any other sector for that matter) generally requires a competitive business environment. This means looking at the financial, logistics and bureaucratic costs of doing business and if a functioning public sector is in place.

Increasing the value-added of services could also be a policy target. Additionally, governments in Emerging Asia could consider long-term policies that promote and incentivize formalization of informal service sector activities. A big chunk of service sector activities in many Emerging Asian economies is considered informal. Gradually transforming informal activities to formal transactions can help expand the tax bases of national governments. It can improve the growth potential of currently informal enterprises through relatively less restrictive access to finance as well as better access to business infrastructure and industrial linkages.

Take China, for example. Fostering service industries as a new source of growth is at the center of policy discussions. The 13th Five-Year Plan for National Economic and Social Development (2016-2020) emphasizes inclusive growth aimed at ensuring that a greater proportion of Chinese citizens reap the benefits of economic growth. The goal is to further the share of the tertiary sector in GDP to 56% by 2020. Over the course of the 12th Five-Year Plan (2011-2015), China outperformed its target to increase the value-added of the service sector as a percentage of GDP of 47% and, in fact, reached 50.5% in 2015. Thus, the value-added of the tertiary industry accounted for a larger share of GDP than that of the secondary industry, which demonstrates the country's capability to implement plans. As part of this endeavor, China intends to boost the development of modern services, further open them to foreign competition and improve the

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Indian technicians check tablet computers at Canadian company Datawind Manufacturing's plant at the GMR Complex of Rajiv Gandhi International Airport in Hyderabad on Dec. 6, 2016.

business environment to help advance toward specialization and higher value services.

The benefits of structural reforms, including fostering competitive and transparent markets, help stimulate innovation and efficiency, as well as an increased range and variety of services available to consumers and end-users.

If "key policy" and "structural reform" in your questions mean opening up the sector to foreign capital, then additional foreign capital will present an opportunity for service enterprises to expand operations and potentially create more quality jobs. Skill and technological transfers through liberalization could also help raise factor productivity. Economies must strive to increase their absorptive capacities to maximize the benefits from foreign capital intake. Some measures governments can put in place include making sure that available skills in the labor market match the demand of industry, improving basic physical and financial infrastructure, and keeping the business climate predictable with known regulations. Overall, further developing institutional capacities across Emerging Asia remains a priority to enhance human capital, foster competition and innovation, and facilitate infrastructure development.

Assessing the impact of policies on the service sector and prioritizing among them is essential to ensure the reforms are working. Yet it is a complicated exercise, not least because of the lack of comparable data. To help plug that gap, the OECD produces a unique database that monitors barriers to entry into the domestic service sector (http://www.oecd.org/tad/services-trade/services-trade-restrictiveness-index.htm). The policy measures are categorized under five policy areas: (i) restrictions on foreign ownership and other market entry conditions; (ii) restrictions on the movement of people; (iii) other discriminatory measures and international standards; (iv) barriers to competition and public ownership; and (v) regulatory transparency and administrative requirements. In Emerging Asia, data are available for China, India and Indonesia. They show how these countries compare with OECD and other emerging economies in terms of restrictiveness to trade in services.

Challenges for Each Country

JS: Why will the service sector in the tourism industry, such as in Indonesia, be a medium-term focus for developing economic conditions?

Pezzini: The tourism sector in Emerging Asia has a large potential to contribute to the economy and support inclusive growth. As one of the most labor-intensive sectors (after agriculture), tourism is a segment of the service sector that could potentially absorb a large number of workers in the countries in the region, such as Indonesia and the Philippines.

Indonesia, in particular, still has large room to improve its tourism sector. Tourist arrivals are still much lower than in neighboring Malaysia, Thailand and Singapore. Indonesia attracted approximately 9.4 million overseas visitors in 2014 compared with 27 million in Malaysia and 24 million in Thailand. The country expects to increase tourism's economic contribution to 8% of GDP by 2019, targeting 20 million foreign tourists, 275 million domestic tourists, foreign exchange revenue of IDR 240 trillion, 13 million new jobs and a rise in the country's world tourism competitiveness index rating to 30.

The government of Indonesia implemented several policy measures to achieve the targets, including expanding the list of countries eligible for free tourist visas, deregulating the Clearance Approval for Indonesian Territory for yachts entering the country's territory, and launching the 10 priority tourism destinations program in 2016.

JS: How will the service sector, such as in the Philippines, help the government create new jobs?

Pezzini: The service sector accounts for a large share of economic activity in the Philippines. Services-led growth in the Philippines has not always been particularly successful at creating productive jobs, however. If the country were to develop its activities in industries with higher productivity, this might help create new jobs.

The business process outsourcing (BPO) industry is a possible example. BPO took off in the early 2000s and grew to make the Philippines the third-largest BPO destination in the world. The IT and Business Process Association of the Philippines estimated that employment in the sector surpassed 1 million in 2014. These jobs do, however, tend to go to more educated workers.

Tourism is another promising sector that could potentially absorb a large number of workers in the Philippines. It can also offer relatively high pay for less-educated workers. The expansion of the tourism industry in the Philippines has been constrained, however, by difficulties in starting businesses, by safety and security concerns, by inadequate standards of health and hygiene, and by underdeveloped infrastructure. Investments to improve the quality of human resources and create new jobs are key. Expectations for continued investment and infrastructure development mean that construction should provide employment opportunities, if necessary skills can be developed.

Globalization of Service Sector

JS: What is the outlook for trade in services for Asian countries?

Pezzini: Trade in services drives the exchange of ideas, know-how and technology. It helps firms cut costs, increase productivity, participate in global value chains and boost competitiveness. Consumers benefit from lower prices and greater choice.

The service sector in ASEAN remains significant and continues to grow steadily. As of 2016, this sector accounted for between 38% and 69% of GDP in the 10 ASEAN member countries.

World Bank data as of 2015 show that, on average, trade in services comprises 20.7% of Emerging Asia's total trade — about 7 percentage points lower than OECD countries (27.1%). The shares of services in total trade of both regions in 2015 are the highest since 2011.

An important component of the ASEAN Economic Community's vision is to achieve the free flow of trade in services supported by the free movement of skilled workers within ASEAN countries. To promote more trade in services between ASEAN countries, barriers in the service sector need to be eliminated and decreased steadily. Lifting these barriers, together with complementary measures to promote the movement of workers, will boost trade in services among ASEAN countries and beyond.

JS: How do governments eliminate the barriers to service trade?

Pezzini: Trade and investment barriers and domestic regulations often impede international trade in services. For this reason, the OECD Service Trade Restrictions Index (STRI) helps identify which policy measures restrict trade. The STRI provides decision makers with information and measurement tools to foster international trade in services and identify best practice to design and implement domestic reforms in priority areas (http://www.oecd.org/tad/services-trade/services-trade-restrictiveness-index.htm).

Under the ASEAN framework, governments are aware of the need to eliminate restrictions so that ASEAN service suppliers can expand and compete across national territories, as long as they comply with the minimal rules imposed by the host country.

Mutual Recognition Agreements (MRAs) are also important because they facilitate trade in services through mutual recognition of authorization, licensing or certification of professional service suppliers among member states.

As of 2016, ASEAN has signed eight MRAs but only two are actively used: in the engineering and nursing professions, according to the Economic Research Institute for ASEAN and East Asia (ERIA). ASEAN's MRAs, which involve strict immigration rules set by national laws, are very different from those of the EU and Australia-New Zealand, where the free movement of professionals is permitted. With the ratification of the Movement of Natural Persons (MNP) Agreement last year, this agreement will facilitate the movement of skilled workers not only in the eight MRA sectors but also in the rest of the service sector within ASEAN countries.

Digital Economy as New Opportunity

JS: How will the digital economy become a new

engine of growth for Asia's service sector and manufacturing sector?

Pezzini: Digitalization has broad implications for all economic sectors, and will continue to reshape manufacturing and services in Emerging Asia, though it will be important to properly understand its pros and cons, the stop-gap measures that can address negative impacts, the influence of an economy's level of digitalization, and the factors that have driven successful cases of transformation.

Digitalization is a major driver of the "Next Production Revolution" defined as the confluence of digital technologies, biotechnology, new materials and new processes that will have far-reaching consequences for productivity, jobs, skills, the environment and our lives in general. Harnessing the potential of the digital economy is critical to breaking the low growth/low-productivity trap in which the global economy is caught.

Recognizing this reality, Emerging Asia is making significant progress in the development of e-commerce and new information and communication technologies. These are particularly important sectors to the region's small and medium-sized enterprises. In Malaysia, for instance, e-commerce grew from 2010 to 2015. The use of e-commerce by the ICT industry has been growing rapidly due to the strong growth in the ICT manufacturing and services sub-sectors as well.

The OECD is exploring the far reaching consequences of digitalization on economies and societies and has just released some key policy recommendations for the G20 (https://www.oecd.org/g20/policy-recommendations-for-digital-transformation-in-the-G20.pdf).

An in-depth study related to the impact of digitalization on manufacturing and services in Emerging Asia will be discussed in the upcoming edition of the OECD *Economic Outlook for Southeast Asia, China and India* due to be released later this year.

JS: How will the digital economy transition, such as in Thailand, be beneficial for the advancement of the service sector?

Pezzini: Some countries in the region have started developing their digital economy. Thailand, for instance, has a vision of maximizing digital technologies in all areas of its society and economy and of developing infrastructure in terms of innovation, data, human capital, and other digital resources. The government is promoting "Thailand 4.0", a vision to develop a new economic model to help the country escape the middle-income trap.

Further developing the digital economy has benefits, such as facilitating trade, creating jobs, and empowering both women and young entrepreneurs in the region. It also develops the scope for businesses, especially micro, small and medium enterprises (MSMEs), including those in the service sector, to participate in regional and global value chains and to gain expanded access to markets and suppliers.

Outlook for Service Sector

JS: What is the fundamental policy for governments to promote the service sector in Asia?

Pezzini: Policies to promote the service sector vary in terms of focuses and approaches in each country. However, some initiatives have been implemented at regional level to promote the liberalization of the sector. ASEAN members, for instance, have implemented the MRAs with three priorities: i) job creation; ii) labor market monitoring; and iii) facilitating skilled labor mobility.

A new initiative has also been launched called the *ASEAN Qualification Reference Framework* (AQRF) that covers the education and training sectors. It serves as a common reference to compare qualifications of skilled labor across ASEAN countries. The AQRF's mechanism across ASEAN countries can boost the use of MRAs that are already established.

Labor mobility is indeed essential in expanding the service sector potential in the region. When countries agree on certain qualities and standards of professionals, job matching can take place systematically and effectively in areas where expertise is lacking domestically. With this mechanism in place, mobility among skilled labor can improve somewhat in the short and medium term, without ratification of the MNP accord by all member countries.

JS: How can governments eliminate impediments in the service sector?

Pezzini: ASEAN governments are on track. They are working to make sure that all regional goals related to liberalization of the service sector are reflected in national policies. This holds true especially in the case of skilled labor mobility among ASEAN countries. Greater harmonization of regulatory frameworks is part and parcel of this process.

JS: How will the optimization of the service sector in Emerging Asia contribute to future economic growth?

Pezzini: Make no mistake about this: the service sector in ASEAN countries remains significant and continues to grow steadily. The free flow of trade in services needs to be supported by the free movement of skilled workers for it to grow sustainably not only within national borders but also throughout the region. Lifting and eliminating barriers in the service sector will take place simultaneously with the free movement of skilled workers for sustainable growth in the service sector in ASEAN and among its regional trading partners.

I believe that the further development of the service sector is a key component of Emerging Asia's development strategies to escape the middle-income trap and change the growth model from one driven by factor accumulation to one driven by knowledge and innovation. JS

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