

ADB Economics Working Paper Series



The Service Sector in Lower-Income Asian Economies

Gemma Estrada, Yubraj Acharya, Aaron Batten, Peter Brimble,
Poullang Doung, Mirzo Iskandar Gulamov, Mohammad Zahid Hossain,
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CONTENTS

ABSTRACT	v
I. INTRODUCTION	1
II. COUNTRY EXPERIENCES	2
A. Bangladesh	6
B. Cambodia	8
C. Nepal	9
D. Papua New Guinea	10
E. Uzbekistan	12
F. Viet Nam	14
III. CONCLUDING OBSERVATIONS	16
REFERENCES	15

ABSTRACT

In the past 10 years, the service sector has been a significant contributor to overall economic growth in Bangladesh, Cambodia, Nepal, Papua New Guinea, Uzbekistan, and Viet Nam. Sector growth has been supported by strong industrial growth in some while in others the critical factors have been liberalization, structural reforms, government support, and foreign investments. In order to increase the labor productivity of the sector and realize its potential to contribute to inclusive growth, these countries must address gaps in human capital and the higher costs of setting up new businesses and of doing business that stifle entrepreneurship and private enterprise. These impediments also stand in the way of developing the industry sector and of broader economic growth and development. Policy reforms that ease those impediments will help to achieve balanced growth in which the service and industry sectors support and reinforce each other. As services tend to be more labor intensive, they can foster inclusive growth by serving as an engine for creating jobs.

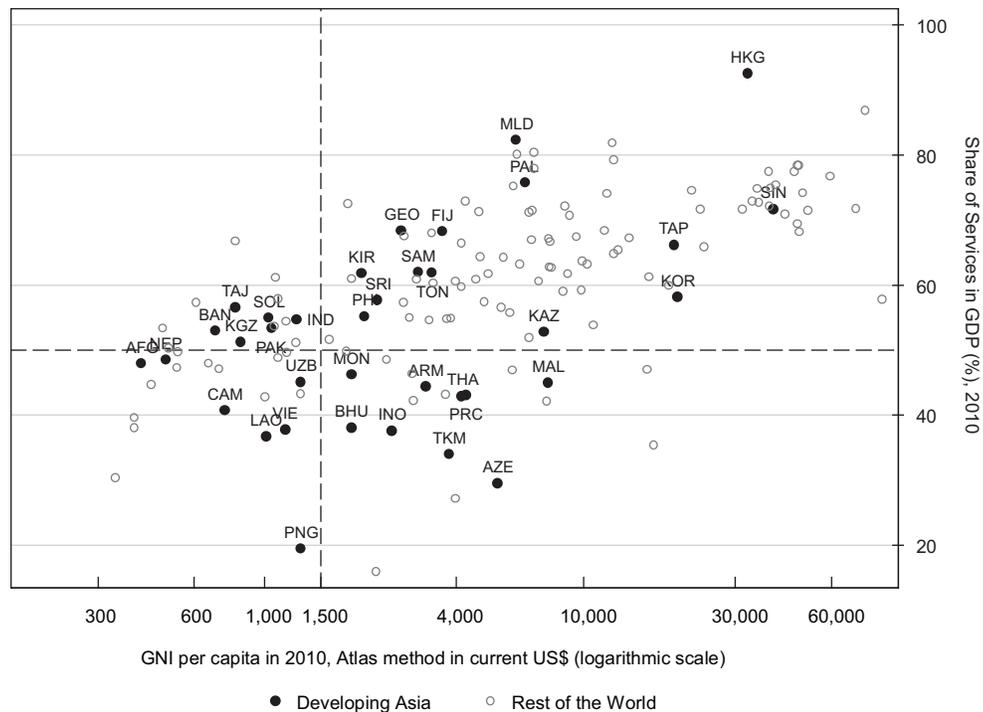
Keywords: Services, structural change, growth, Asia

JEL Classification: L8, 014, 040

I. INTRODUCTION

A stylized fact of economic structural transformation is that the share of services in gross domestic product (GDP) tends to rise with per capita income. Across the world, the share of services tends to be smaller for lower-income countries (Figure 1). In developing Asia, however, the sector's share in lower-income economies varies from 20% to 57%. We define lower-income economies as those with per capita incomes of about \$1,500 or less in 2010 and that belong to the lower one-third of the per capita income distribution in the region. While Cambodia, the Lao People's Democratic Republic (Lao PDR), Papua New Guinea, Uzbekistan, and Viet Nam have service output shares that are low relative to other economies at a similar stage of development, Bangladesh, India, the Kyrgyz Republic, Nepal, Pakistan, and Tajikistan have shares of around 50% or more. What is common among the first set of countries, except for Cambodia, is their relatively high levels of industrialization: industry's share of output ranges between 30% and 45%, compared to only 15%–30% in the latter set of countries. Therefore, there are some lower-income countries where the share of services in GDP is relatively low but the share of industry is comparable to or even higher than in countries at higher income levels.

Figure 1: Services Output Shares at Various Per Capita Income Levels



AFG = Afghanistan; ARM = Armenia; AZE = Azerbaijan; BAN = Bangladesh; CAM = Cambodia; FIJ = Fiji; GEO = Georgia; IND = India; INO = Indonesia; KAZ = Kazakhstan; KOR = Rep. of Korea; KGZ = Kyrgyz Republic; LAO = Lao PDR; MAL = Malaysia; MLD = Maldives; MON = Mongolia; NEP = Nepal; PAK = Pakistan; PNG = Papua New Guinea; PHI = Philippines; PRC = People's Rep. of China; SAM = Samoa; SIN = Singapore; SRI = Sri Lanka; TAP = Taipei, China; TAJ = Tajikistan; THA = Thailand; TON = Tonga; TKM = Turkmenistan; UZB = Uzbekistan; VIE = Viet Nam.

Sources: ADB, *Asian Development Outlook* database; World Bank, *World Development Indicators* online database (accessed 16 April 2012).

In some lower-income economies, strong service sector growth has been supported by a fast-growing industrial sector. Although still relatively small, if recent growth trends continue, their service sectors are expected to expand substantially in the coming years. The sectors in Uzbekistan and Viet Nam grew in the past 5–6 years at an annual average of 13% and 8%, respectively and their industrial sectors have rapidly expanded as well, leading to strong overall economic growth. The service sector of Cambodia in the same period grew at about 7% a year, which was equal to the growth of its industrial sector. Despite its small service economy, the average growth of 9.5% in Papua New Guinea was higher than its industrial growth at 7.9% in the same period.

Other factors that have helped service sector development in lower-income countries in addition to industrial growth were liberalization, structural reforms, explicit government incentives, foreign investments, and service trading. In Viet Nam, services liberalization led to the rapid expansion of retail, telecommunications, and transportation industries. In addition, the country's entry to the World Trade Organization in 2007 and several bilateral trade agreements have led to higher foreign direct investment (FDI) in services. In Papua New Guinea, the removal of the state monopoly in the mobile telephone market, greater competition in the aviation industry, and structural reforms in the financial sector contributed to robust output and employment growth in the service sector. In Uzbekistan, direct government support for services was provided through tax incentives to small businesses in financial and banking services, as well as to insurance firms and health and recreational centers. Incentives were also provided by the government to banks to extend loans to small and medium-sized enterprises, including those in the service sector. In Cambodia, strong tourism has helped the expansion of the country's hotels and restaurants, transport and communications, and retail trade industries.

In South Asian lower-income economies, the surge of service exports, particularly in information and communication technology (ICT) and related industries has been an important driver of service sector development (Ghani 2010). ICT developments can be largely attributed to regulatory reforms and foreign investments (Cecot and Wallsten 2010). Although the service sectors of South Asian economies have grown markedly, their industrial sectors have lagged far behind.

Our paper reviews the experiences of the service sectors in six lower-income countries, spread across different subregions of developing Asia. The countries are Bangladesh, Cambodia, Nepal, Papua New Guinea, Uzbekistan, and Viet Nam. Our country analysis covers an overview of the service sector, main barriers to growth of the sector, and policy options to unleash potential of the sector to contribute to inclusive growth.

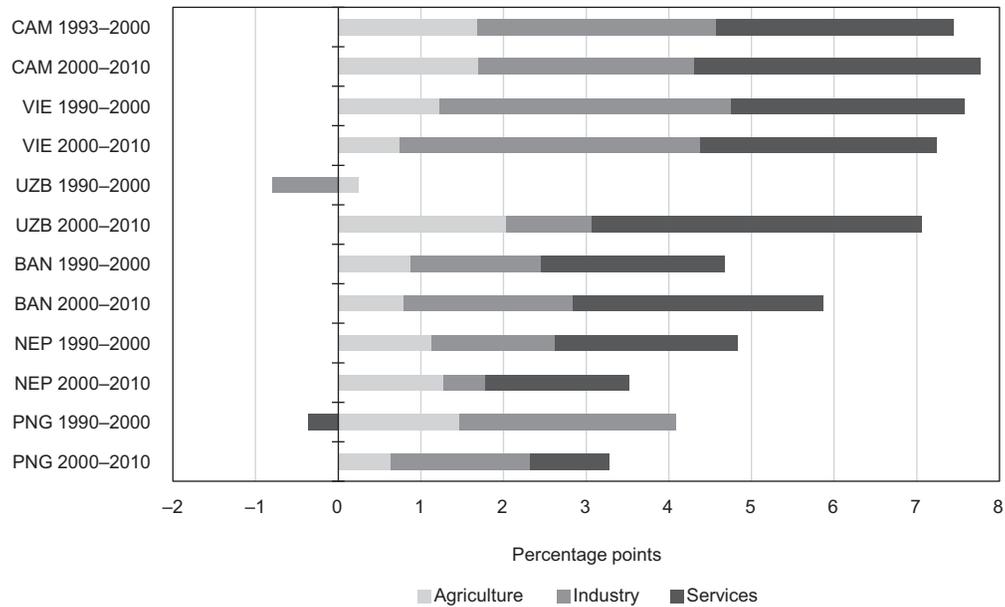
II. COUNTRY EXPERIENCES

In the past decade, the service sector has been a huge contributor to overall growth across economies in developing Asia (Noland, Park, and Estrada 2012). This pattern is also evident in some lower-income economies in the region. In Bangladesh, Cambodia, Nepal, and Uzbekistan, services contributed more to growth than either industry or agriculture from 2000 to 2010. What is striking about these economies is that compared to the 1990s, growth proceeded more rapidly from 2000 to 2010, with the service sector as the key driver (Figure 2). In Papua New Guinea and Viet Nam, industry contributed more to growth, but services still contributed significantly at about 30% and 40%, respectively. The service sector constituted about 53% of the output in Bangladesh in 2010 compared with 48.3% in 1990; 48.5% in Nepal compared with 32.1%; and 45.1% in Uzbekistan compared with 34.3% (Figure 3). These figures are higher

than those of the People’s Republic of China (PRC), but somewhat comparable to those of Malaysia.

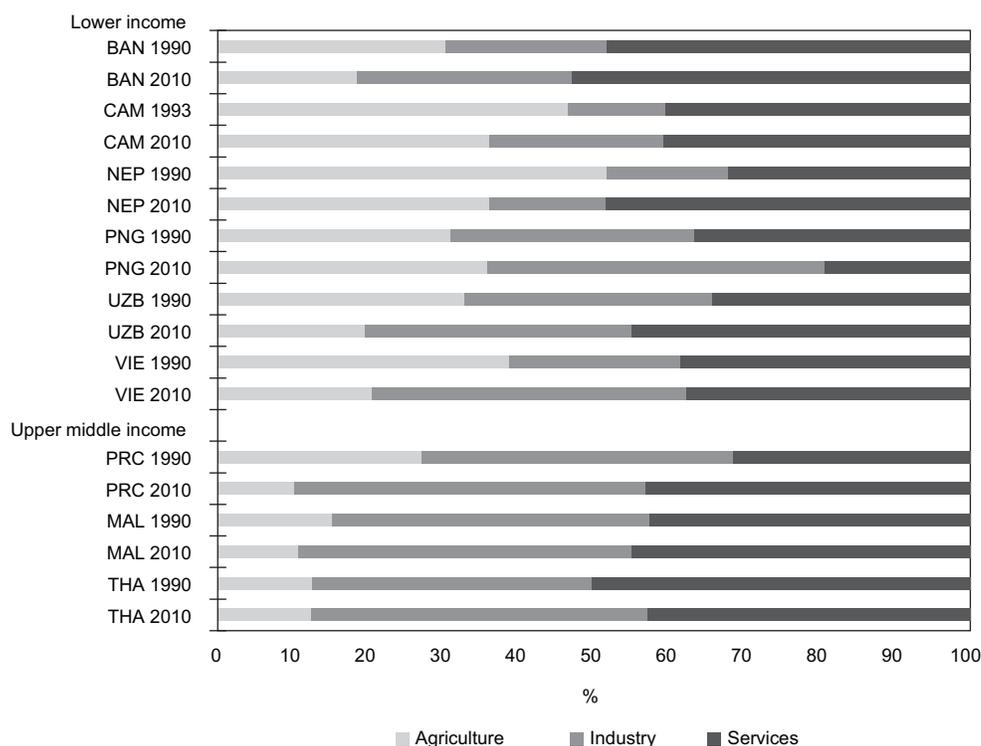
A key issue is whether growth in the service sector has led to significant job creation and to improvements in productivity. In terms of employment, lower-income economies are still primarily agricultural, but there is some evidence that services have contributed substantially to employment growth in the past decade. In Bangladesh, services contributed to about one-third of the employment growth from 2000 to 2010, which was more than industry did. In Viet Nam, the contribution of services to employment growth was close to that of industry, at around 50% for about the same period. In Cambodia, the contribution to employment growth between 2000 and 2008 was only about 23%, but it was still more than double that of industry.

Figure 2: Contributions to Growth by Sector



BAN = Bangladesh, CAM = Cambodia, NEP = Nepal, PNG = Papua New Guinea, UZB = Uzbekistan, VIE = Viet Nam.

Source: Authors’ estimates based on data from World Bank, World Development Indicators online database (accessed 16 April 2012).

Figure 3: Output Shares by Sector

BAN = Bangladesh, CAM = Cambodia, MAL = Malaysia, NEP = Nepal, PNG = Papua New Guinea, PRC = People's Republic of China, THA = Thailand, UZB = Uzbekistan, VIE = Viet Nam.

Source: Authors' estimates based on data from World Bank, World Development Indicators online database (accessed 16 April 2012).

As shown in Noland, Park, and Estrada (2012), the productivity of the service sector in developing Asian economies is much lower than that of advanced countries, with lower-income economies having the biggest productivity gaps. As in Asia's middle-income economies, traditional services dominate in lower-income economies. Considered part of modern services, financial services account for only around 2%–4% of the total value-added of lower-income economies, compared to about 4%–8% of the PRC, Malaysia, and Thailand (Table 1). As a share of output, the service sectors of Bangladesh, Cambodia, Nepal, and Uzbekistan are already comparable to or even higher than those of the upper middle-income economies, but they need to transform their productivity levels as our estimates indicate that they are only about 22%–30% of the average for the PRC, Malaysia, and Thailand. Their low income levels imply a large scope for catch-up and for productivity increases, as Park and Shin (2012) empirically demonstrate.

Although the services sectors of lower-income economies are expanding, the dominance of traditional activities clearly indicates that they remain in the “first wave” of service sector growth, following Eichengreen and Gupta (2009). As their study highlights, the transition to the “second wave”, in which modern services become more important, requires countries to be more open to information technologies and to taking advantage of opportunities for cross-border trade in services.

Table 1: Share of Services in Value-added, 2010

Economy	Total Services	Wholesale and Retail Trade	Hotels and Restaurants	Transport, Storage, and Communication	Financial Services	Real Estate and Business Services	Public Administration, Community, Social, Personal, and Other Services
Lower-income							
Bangladesh	53.0	14.9	0.8	10.7	1.8	6.8	17.9
Cambodia	40.7	9.9	4.8	8.1	1.5	5.8	10.7
Nepal	49.5	14.4	1.6	8.5	4.1	8.4	12.5
Uzbekistan	45.1	8.2	0.2	17.1	3.9	0.0	15.7
Viet Nam	42.9	16.4	4.6	4.8	2.1	4.0	11.1
Upper middle-income							
PRC	43.4	8.5	2.1	7.3	5.2	9.1	11.2
Malaysia	46.0	11.9	2.3	6.5	8.5	7.1	9.7
Thailand	43.0	13.1	4.7	6.8	4.1	2.3	12.0

PRC = People's Republic of China.

Note: While it would have been ideal to combine modern services (comprising communication, finance, and business services) into one group, this is not possible due lack of more detailed data among lower-income economies.

Source: Authors' estimates based on data from CEIC Data Company (accessed 5 December 2012) and Uzbekistan State Statistics Committee.

The increasing globalization of services provides a huge opportunity for lower-income economies to harness growth by developing their service sectors. Using the experience in South Asia, Ghani (2010) highlights that globalization of service exports provides opportunities for developing countries to find areas outside manufacturing where they can specialize and achieve dramatic growth. Lower-income economies can learn from the experience of India, which has successfully exported ICT and business process outsourcing (ICT-BPO). One key factor that has driven India's success is its human resources, particularly, the size and competence of its ICT-BPO workforce (Mitra forthcoming). This indicates the need for lower-income economies to bolster their human capital to successfully take part in the global trade in services and to sustain sector growth.

In addition to addressing gaps in human capital, there are other barriers that lower-income economies need to overcome to unleash the potential of their service sectors. Difficulty of doing business can severely limit services growth, as well as overall economic growth. Lower-income countries tend to fare poorly in terms of providing a conducive business environment. For example, Papua New Guinea ranked 101, Cambodia ranked 138, and Uzbekistan ranked 166 out of 183 economies overall in the World Bank's *Doing Business* report in 2012. Heavy regulatory burden, costly and unreliable supply of basic utilities such as electricity, lack of a skilled workforce, and poor governance are all detrimental to the growth of the service sector. There is also a clear need to achieve robust industrial growth, in order to generate growth opportunities for complementary service industries. For lower-income countries, which have managed to spur relatively high industrial growth alongside strong service sector growth, sustaining the growth momentum in both sectors will remain an important challenge.

A. Bangladesh

The annual growth rate of the service sector in Bangladesh reached 6.3% between fiscal year (FY) 2008 and FY2012, maintaining the momentum achieved from FY2003 to FY2007. Transportation, storage, and communication; hotels and restaurants; and financial services all grew robustly. During the past 5 years, wholesale and retail trade accounted for 28.5% of services growth, closely followed by transport, storage, and communication at 24.6% (Figure 4). Improvement in infrastructure, better macroeconomic management, and regulatory reforms in banking, telecommunications, health, and education services all contributed to the strong growth in services.

Traditional services like wholesale and retail trade and transport and storage are more dominant than modern ones like financial services and telecommunication, although lately, the latter has been growing quite rapidly. In the last 5 years, financial services output grew by over 9% a year. Employment in finance, business services, and real estate combined also expanded at a faster rate in recent years (Figure 5).

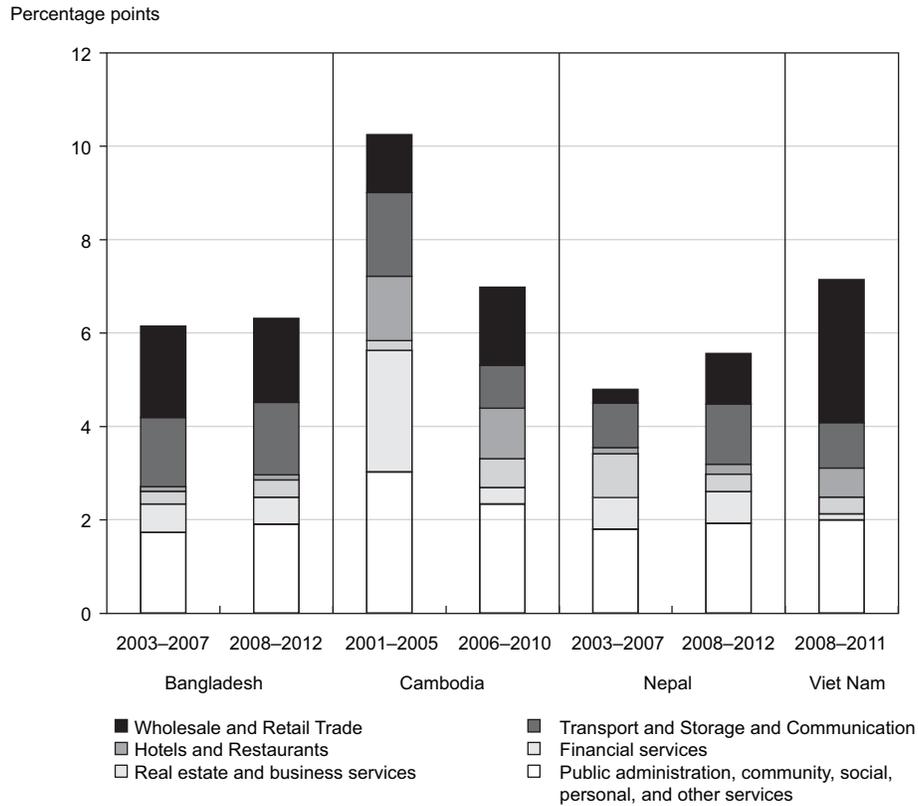
The robust growth in financial services reflects the country's significant progress in delivering finance, as well as improving financial inclusion after its pioneering work in microfinance. Bangladesh Bank (the central bank) strongly encouraged credit flows to marginal farmers, those from underdeveloped areas, and women through various measures such as expanding credit lines for small- and medium-sized enterprises, refinancing schemes with microfinance institutions, opening facilities for small depository accounts for farmers, and promoting mobile phone banking.

The liberalization of the telecommunications industry that began in the 1990s led to the industry's rapid growth in the past 5–10 years. Liberalization led to issuing more licenses to private sector operators and consequently to the rapid increase in demand for mobile phone subscriptions from 3.8 million in 2004 to 89.5 million as of March 2012.

Like other South Asian countries, Bangladesh experienced a surge in ICT exports. The country's ICT exports rose from \$24.8 million in 2000 to \$458.7 million in 2011, outperforming both Pakistan and Sri Lanka.

Notwithstanding recent gains, there are several factors that continue to inhibit more rapid growth in services. One key constraint is the lack of skills resulting from the poor quality of education and another is the weak investment climate that restricts FDI inflows and transfers of technology to the service sector. To acquire the skills needed to make the transition to higher value-added modern services, investing in education and improving its quality are crucial. The country also needs to invest more in physical infrastructure and in providing basic utilities. There is also a need to improve the county's business climate through deeper policy and regulatory reforms. In financial services, systemic risks in the banking sector arising from liquidity pressures, limited prudential oversight, and weak bank governance must be addressed, and risk management controls, most notably in state-owned commercial banks, must be adopted.

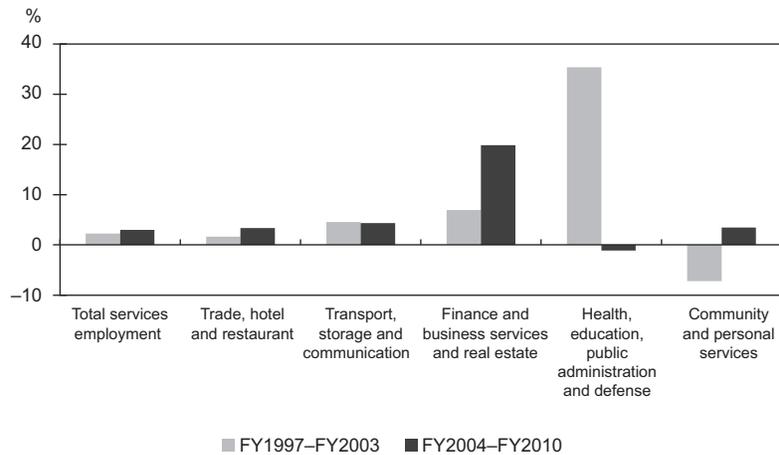
Figure 4: Contributions to Services Growth in Bangladesh, Cambodia, Nepal and Viet Nam



Note: Data for Bangladesh and Nepal refer to fiscal years.

Source: Authors' estimates based on data from CEIC Data Company (accessed 5 December 2012).

Figure 5: Employment Growth by Service Industries in Bangladesh, FY1997–FY2010



FY= fiscal year.

Sources: Bangladesh Bureau of Statistics, Labor Force Survey, various issues; ADB estimates.

B. Cambodia

From 2006 to 2010, Cambodia's service sector expanded by 7.0% annually, which was slightly greater than the country's overall economic growth of 6.7%. As seen in Figure 4, the growth in services was mainly driven by expansion in wholesale and retail trade and in hotels and restaurants, which altogether accounted for nearly 40%.

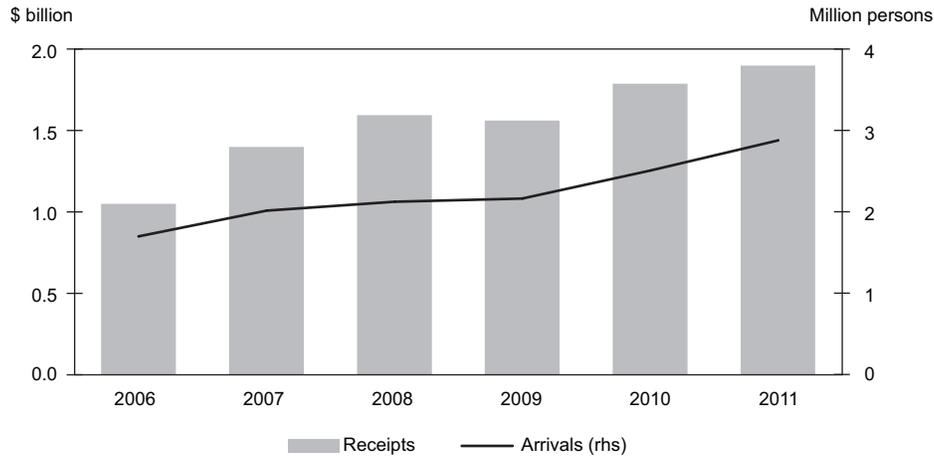
Cambodia's service sector has largely been driven by tourism, which has been a major earner of foreign exchange and an important source of income and employment for the country's formal and informal sectors (Figure 6). In 2010, the tourism industry generated 302,578 jobs (ADB 2005, 2010).¹ Large international tourism arrivals have supported the expansion of hotel and restaurant businesses, as well as other industries such as wholesale and retail trade, and transport and communications, all three of which grew between 6% and 9% a year from 2006 to 2010.

A significant development in Cambodia's service sector has been in financial services. While they accounted for only about 1.5% of value-added, this industry grew at a robust rate of 17% annually from 2006 to 2010. Following the country's transformation into a market economy in the early 1990s, financial services have expanded rapidly, driven by strong private sector participation and supported by growing public confidence. Private sector credit increased to about 30% of nominal GDP in 2011 from 12.2% in 2006 and 6% in 2001. A recent development expected to further spur growth in financial services was the creation of the Cambodian Securities Exchange in July 2011. Stock trading commenced on 18 April 2012 following an initial public offering of \$21 million of shares of the Phnom Penh Water Supply Authority, one of three state-owned enterprises planned for listing in 2012.

In recent years, real estate activities have been marked by significant developments. From 2005 to 2008, output expanded at 8.6% annually, but this led to overheating. With the onset of the global financial crisis and the subsequent dry-up in liquidity, in 2009 the prices of commercial and residential real estate declined by about 33% and 28%, respectively. Moreover, real estate output contracted from 2009 to 2010, but a doubling in the value of approved construction projects in 2011 suggests a degree of recovery.

As with other sectors in Cambodia, services remain hampered by (i) inadequate infrastructure such as transport and basic utilities, especially in rural areas; (ii) the high cost of electricity, as well, as logistics and transportation costs; (iii) inadequate implementation of policies, laws and regulations, including numerous bureaucratic procedures; (iv) tax administration, governance, and corruption issues; and (v) lack of a skilled workforce and of institutional capacity. These constraints need to be addressed to drive down the cost of doing business and to further improve the competitiveness of the service sector. For the tourism industry, authorities should exert greater efforts to help diversify and strengthen value chains, including within the Greater Mekong Subregion and the Association of Southeast Asian Nations networks. This will enable the tourism industry to fully tap into regional markets and to improve its competitiveness.

¹ The Greater Mekong Subregion Strategy Draft Final Report (2005, p. 33) indicates that one job is generated per \$5,159 expenditure in 2009 dollars.

Figure 6: Tourism Indicators, Cambodia

Source: Ministry of Tourism.

C. Nepal

From FY2008 to FY2012, Nepal's service sector grew by an average of 5.6% per year, which was greater than the growth in agriculture (4.1%) and industry (1.9%). Among the biggest contributors to that growth were wholesale and retail trade and transport, storage, and communications (Figure 4). Wholesale and retail trade has remained the biggest subsector, buoyed by strong remittance inflows and tourism earnings.

The country's service sector demonstrated strong resilience to the global economic crisis despite its heavy reliance on tourism. To support tourism, campaigns such as the "Visit Nepal Year 1998" and "Nepal Tourism Year 2011" were initiated, although the latter seemed to have attracted mostly budget tourists from neighboring countries as reflected by a significant rise in tourist arrivals without a commensurate rise in earnings.

The service sector is largely composed of traditional activities, but financial services are gradually gaining ground. As of FY2012, financial services accounted for about 9% of service value-added, up from 6% in 2001. From FY2008 to FY2012, the output of financial services rose by 5.8% annually, supported by a growing number of banks and financial institutions (Figure 7). As of July 2011, there were 31 commercial banks, more than 80 development banks, and 79 finance companies. However, financial services exhibited some moderation in growth in FY2011, as deposits were reportedly shifted from big commercial banks toward smaller financial institutions, which led to frequent liquidity shortages and a rise in interbank rates. As seen in Figure 4, the contribution of financial services to total services growth declined from FY2008 to FY2012 compared with the previous 5-year period.

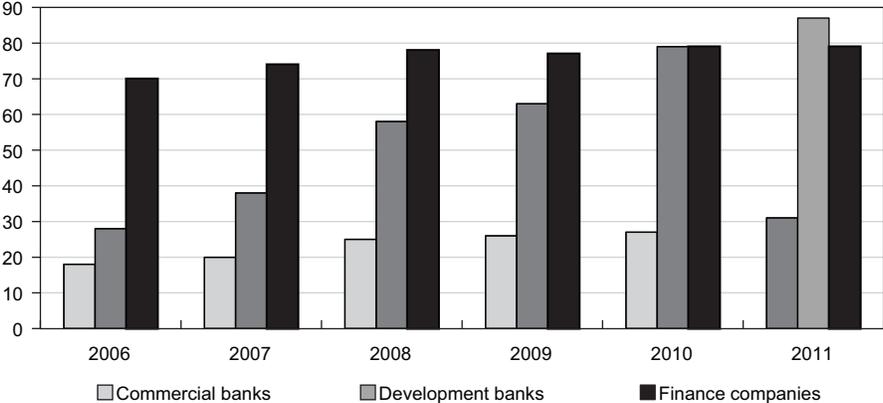
The surge in telecommunications was also behind the rapid growth in the service sector. Telecommunications reached approximately 50% of the total population in 2011, up significantly from 8% in 2007.

Looking ahead, the sector's contribution to growth and poverty alleviation hinges on a number of factors, including how the political scenario evolves and how electricity and fuel shortages and labor market rigidities and tensions are addressed. The timely conclusion of the

peace process and drafting of the constitution will help spur services growth. There is a need to hasten reforms in the Nepal Electricity Authority and Nepal Oil Corporation to help address electricity and fuel shortages. The labor tensions that have caused frequent disruptions in the tourism industry should likewise be immediately addressed.

In financial services, sustained growth will primarily require a return of depositor confidence in the banking industry, which has been adversely affected by liquidity crunches and the dissolution of two banks in 2011. In this regard, the central bank needs to strengthen its supervisory capacity—efforts are underway in this regard—to ensure that proper corporate governance becomes a norm.

Figure 7: Number of Financial Institutions, Nepal



Source: Nepal Rastra Bank. 2011. Banking and Financial Statistics. July.

D. Papua New Guinea

Traditionally, Papua New Guinea’s economy has been dominated by industry, including large mining and oil operations, and agriculture, with cash crop exporters operating alongside much larger but highly diffused subsistence production. In contrast, the service sector has remained small, comprising mostly basic transport, finance, and logistics to support mining and agriculture businesses, as well as wholesale and retail trade. Over the last decade however, this pattern has begun to change and the sector is beginning to diversify. Growth has been remarkable, from an average 2.8% per annum between 2001 and 2005 to an estimated 9.5% per annum between 2006 and 2012, which was greater than growth in the industrial sector (7.9%). Finance, and transport and telecommunications have been major drivers of this growth, expanding by annual averages of 9.4% and of 21%, respectively, between 2006 and 2012.

Several factors have supported this impressive growth in services. The first was an unprecedentedly long period of macroeconomic stability. The economy recorded its 10th consecutive year of growth in 2011, averaging 5.1% annually. Improved macroeconomic conditions were complemented by structural economic reforms that revitalized the banking industry by privatizing the Papua New Guinea Banking Corporation, that strengthened superannuation legislation and its oversight, that improved financial regulations, and that

established the central bank as an independent entity with a clear mandate for price stability.² In 2006, reforms were also undertaken in telecommunications with the removal of the state monopoly in the mobile telephone market. Increasing competition has also been progressively introduced into the aviation sector, with a number of new service providers challenging the state-owned monopoly, Air Niugini, and reducing freight and passenger costs.

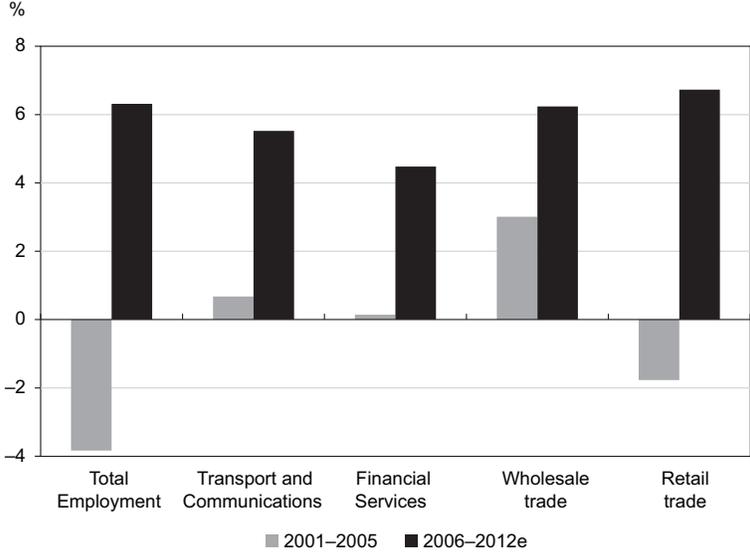
Service sector growth has enlarged employment opportunities. After contracting by an average of 4% per year between 2001 and 2005, employment in the formal sector increased by 6% annually between 2006 and 2012, supported by expansion in the service sector. In particular, employment in transport and telecommunications increased from an average of 0.7% from 2001 to 2005 to 5.5% from 2006 to 2012, while in the same period employment in financial services rose by 4.5% from almost no growth (Figure 8).

Notwithstanding these improvements, the service sector remains small and the economy continues to generate insufficient employment opportunities outside of mining and agriculture. ADB estimates show that despite a decade of economic growth, less than 10% of the economically active population is currently employed in the formal private sector. The service sector also continues to be restricted by the high cost of doing business. Adding to this cost are weaknesses in government service provision with expensive and unreliable basic utilities, uncertain land ownership systems, low educational outcomes, and ineffective maintenance of law and order.

Stimulating the next phase of service sector growth will require a range of coordinated policy actions, including re-invigorating the microeconomic reform agenda to further strengthen competition, lowering bureaucratic barriers to creating new businesses, and addressing the ongoing gaps in government service delivery. Complementing these efforts must also be a renewed effort to improve the quality of service delivery by state-owned enterprises.

² Reforms have spurred impressive growth in financial services, with a range of banking and nonbanking institutions providing a growing range of services. The privatized national bank, renamed the Bank of South Pacific, is now also playing an increasingly important role across the Pacific region, challenging the traditional dominance of major Australian banks in Fiji, Niue, and Solomon Islands. Indirect and multiplier effects have also been substantial, given that increased access will enable the provision of other services in the future, including mobile banking.

Figure 8: Employment Growth in Services, Papua New Guinea



e = estimate.

Sources: PNG National Budget 2012; Authors’ estimates.

E. Uzbekistan

In the past 5 years, the service sector in Uzbekistan has emerged as a key source of value-added and new jobs. It grew by 13.3% a year between 2007 and 2011, well above the 8.7% rate of overall economic growth. Strong growth in services was underpinned by macroeconomic stability, anchored on trade and fiscal surpluses.

Government support has also been instrumental. From 2008 to 2011, the government provided incentives for commercial banks to increase lending to small and medium-sized enterprises, including those in the service sector. In addition, the government provided soft loans to newly established services companies in rural areas through a special microcredit bank that from 2007 to 2010 extended loans amounting to \$14 million for the purchase of capital goods. The government has also granted exemptions on profit and property taxes until 2014 to small businesses in finance and banking, to insurance firms, and to health and recreational centers.

Over the past 5 years, trade, financial services, and telecommunications were the main drivers of growth in the service sector, posting a combined 24% growth in 2011, supported mainly by strong domestic demand and domestic lending. In telecommunications, increasing foreign investment due to low penetration rates was the main growth factor. Between 2008 and 2011, the share of these three in service sector output increased from 31.2% to 35.9% (Figure 9).

Despite the impressive growth in services, a number of barriers and challenges to the sector's sustained growth remain. According to the most recent enterprise surveys, the most important regulatory barriers are (i) informal payments; (ii) excessive bureaucratic costs; (iii) tax burden; and (iv) foreign currency restrictions. The current foreign exchange restrictions in particular render cross border trade in services virtually non-existent. Lack of information on foreign markets, lack of internationalization, and tight government control of the cross-border trade in services are often cited by entrepreneurs as the main limiting factors for entry into cross border trade. Supporting this conclusion are the country rankings in the World Bank's *2012 Doing Business* report. Uzbekistan is ranked 166 out of 183 economies in the ease of doing business category and lowest in the trading across borders category.

Simplifying and increasing the transparency of legal and regulatory policies will encourage increased private sector participation in the service sector. In addition, increased access to finance and foreign exchange would unleash underutilized potential in the cross-border trade in services.

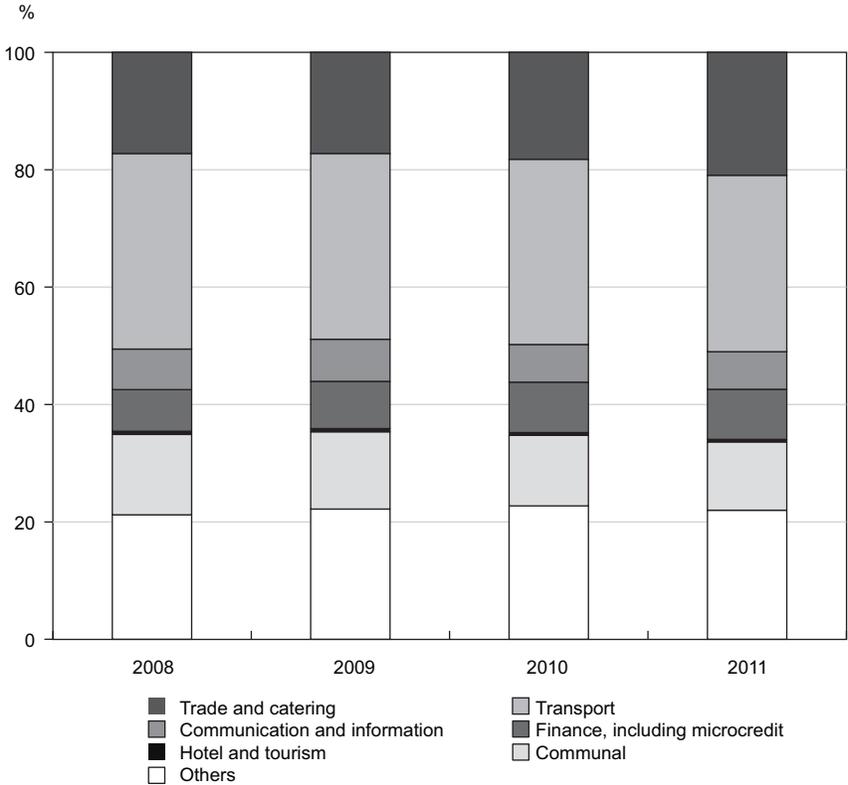
In the domestic service sector, tax exemptions and privileges should be extended not only to small businesses but to other groups as well. As small and medium-sized enterprises accounted for only 46% of service sector output in 2011, supporting more market participants with greater absorptive capacities is also important for sustained service sector growth.

In financial services, competition between private banks and state banks should be promoted to enable access to credit at lower cost for private businesses, particularly micro loans for individual entrepreneurs.

Greater efforts are needed in improving quality of services provided by state-owned enterprises, especially the rail and air transportation monopolies. This should be done through greater management accountability and performance orientation.

With its rich history and culture, Uzbekistan has enormous potential to develop tourism. Even though the country leads the region in the number of UNESCO-designated world heritage sites (there are four of them), tourism accounts for only 0.2% of the service sector output and has seen little growth over the past 5 years. Although tourism is almost fully private, it needs government support to realize its potential, including a comprehensive state-led development strategy that combines improved tourism infrastructure with incentives for private sector operators.

Figure 9: Composition of Service Sector Output, Uzbekistan

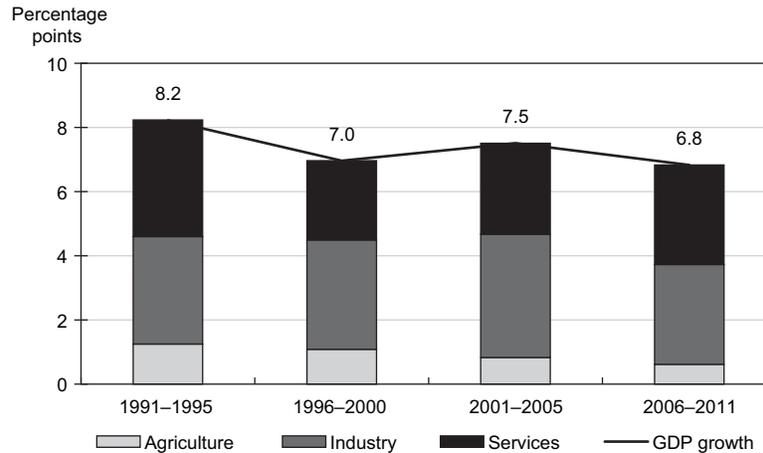


Source: State Statistics Committee.

F. Viet Nam

Viet Nam has achieved impressive growth since the launch of economic reforms in the late 1980s. An average growth rate of 7.4% between 1991 and 2011 has enabled the country to transform itself from among the poorest in Asia to middle-income status, based on the World Bank’s classification. The driver of this growth has mainly been industrial production and exports rather than the service sector though service sector growth has generally kept pace with overall economic growth. From 2006 to 2011 economic growth was relatively balanced, with the industrial and service sectors each accounting for over 40% (Figure 10). Within the sector, the major drivers of growth were finance, transport and telecommunications, hotels, and retail trade (Figure 4).

Strong growth in the service sector was supported by several factors. Robust industrial sector growth increased demand for support services, such as air and land transport, shipping, and seaports. The liberalization of services has also created opportunities for rapid expansion in retailing, telecommunications, and transportation. Furthermore, accession to the World Trade Organization in 2007 and several bilateral trade agreements have paved the way for increased FDI, especially in tourism and in residential and commercial real estate. Almost 50% of FDI from 2008 to 2011 was channeled into the service sector. The adverse impact of the global financial crisis on industry has in fact resulted in the service sector becoming the most significant contributor to growth since 2008.

Figure 10: Contributions to Growth by Sector, Viet Nam

Source: General Statistics Office.

Services are currently a major source of employment in Viet Nam, with retail trade, transport, tourism, and the public administration generating the most jobs in the service sector. Currently around 30% of the total workforce is employed in the service sector.

Despite impressive progress to date, the size of the service sector relative to the economy remains much lower than in other economies at a similar stage of development. Likewise, the share of employment in the service sector remains modest compared to other countries in the region. Further, the share of services in the country's international trade is relatively small and has fallen by over 20 percentage points since 1995 as merchandise exports grew much faster than service exports.

The most important obstacles to developing an efficient service sector relate to competition and mainly stem from the dominant position of state-owned enterprises in many sectors. Among the other important impediments to services are underdeveloped physical infrastructure, scarcity of skilled human resources, and a suboptimal business-enabling environment.

Turning the Vietnamese service sector into a major engine of economic growth will require fundamental reforms of the policies that have an impact on its productivity. In particular, there is an urgent need to enable all firms to compete on an equal footing regardless of ownership. Reforming the financial sector will also be necessary due to the high degree of interconnectedness between state-owned enterprises and commercial banks. Further efforts are required to lower bureaucratic barriers that discourage entrepreneurship. The government also needs to ensure that adequate financial resources are invested to improve physical infrastructure and to close the skill gaps among workers. The government's socioeconomic development strategy recognizes the importance of these structural reforms in improving productivity and competitiveness. It put a priority on reforming state-owned enterprises and the financial sector in 2012 but successful implementation will be key to unleashing the service sector's potential to drive growth and to create employment during the next phase of Viet Nam's economic development.

III. CONCLUDING OBSERVATIONS

The economic significance of the service sector varies widely across the lower-income countries of developing Asia. In some, the share of services in output is lower than in countries at similar income levels while in others the share is higher. Furthermore, the growth of the industrial sector has accompanied and reinforced growth in the service sector in some countries, whereas in others, services have grown despite feeble growth in industry. Despite such heterogeneity, overall the sector is a major source of output, employment, and growth. In light of international historical experience, that the share of services in output rises with per capita income, services will continue to make substantial contributions in lower-income Asian countries. All the more so since those economies are generally growing rapidly.

Park and Shin (2012) found a highly significant negative effect of per capita GDP on labor productivity growth in the service sector. Their analysis is based on the standard empirical framework used in the literature on economic growth and includes a large number of control variables. The finding implies that the lower the initial income level, the higher the subsequent growth rate of labor productivity in services. This supports the well-established empirical evidence of a negative relationship between per capita GDP and GDP growth rate. Since developing Asia's lower-income countries have, by definition, low income levels, they have relatively ample scope for labor productivity growth and hence growth in the service sector. Lower-income countries are still in the early stages of transforming their economic structures so the share of agriculture in GDP is still relatively high, while the shares of industry and services are correspondingly low. Again, there is plenty of room for both to grow in the future.

The big picture of the service sector in lower-income countries in developing Asia is broadly similar to that of the region as a whole. Services already account for a large share of output, employment, and growth and are expected to continue to play a major economic role in the coming years. In order to lift labor productivity of the service sector and hence fully unleash its potential to contribute to inclusive growth, developing Asia, including its lower-income countries, must overcome a wide range of impediments. What distinguishes those countries from the entire region is the severity of those impediments. For example, the lack of human capital, a key factor for many services, is more pronounced in lower-income countries due to their lower average education levels. Above all, the higher costs of setting up new businesses and of doing business in those countries stifle the entrepreneurship and private enterprise that are vital for a dynamic service sector.

Many of the impediments that stand in the way of service sector development in lower-income Asian countries also stand in the way of developing the industry sector and of broader economic growth and development. Therefore, pursuing policy reforms that ease those impediments will help to achieve a balanced growth in which the service and industry sectors support and reinforce each other. For most of developing Asia, this type of well-balanced growth offers the most promising way forward for sustaining rapid growth into the future. Balanced growth also holds the most promise for delivering more inclusive growth which involves more of the population in the growth process and spreads the benefits of growth as widely as possible. In particular, services, which tend to be more labor-intensive than industry, can foster inclusive growth in those countries by serving as an engine of job creation.

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The Service Sector in Lower-Income Asian Economies

This paper reviews the barriers to service sector development and policy options to unleash the potential of services in Bangladesh, Cambodia, Nepal, Papua New Guinea, Uzbekistan, and Viet Nam. The paper highlights the need for policy reforms that ease impediments to achieving balanced growth in which the service and industry sectors support and reinforce each other. As services tend to be more labor intensive, they can foster inclusive growth by serving as an engine for creating jobs.

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