

## Development of services sector for economic diversification and integration in North and Central Asia

A key medium-term policy challenge faced by North and Central Asian economies is to gain competitiveness beyond the export of primary commodities. Among other measures, doing so requires improving the services component of the production process, which in turn would facilitate structural diversification and enhance regional economic integration. These services, also known as backbone infrastructure services or producer services, have direct consequences for adding value in production processes.

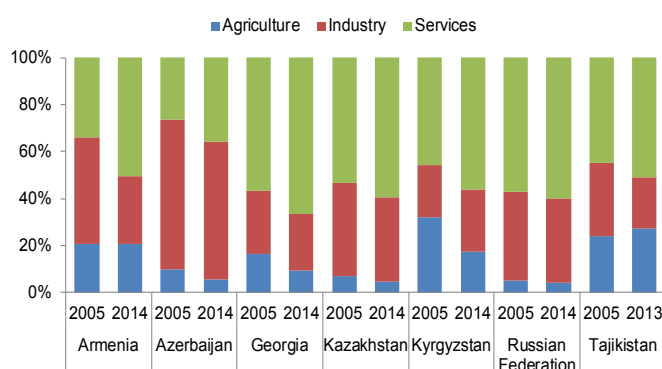
More than two decades after the end of the central planning system, the role of services in the subregion remains limited. While the share of services in GDP increased in most subregional economies between 1993 and 2013 (see figure 1), activities often involve small-scale trading rather than the business services that are required in a modern economy or by those intending to participate in global value chains. Furthermore, lack of adequate data measurements significantly reduces policy-makers' understanding of the role services play in economic diversification, as well as their capacity for evidence-based policymaking.

The absence of such business-friendly services is largely due to the underdeveloped state of the market economy, albeit to varying degrees in the subregion, and consequent lack of demand. Improvement in backbone services is a precondition for such demand to emerge. For example, the benefits of services reform are seen only when reforms in both essential backbone services and complementary services occur.<sup>1</sup> In an ADBI study that examined the impact of better infrastructure services on economic growth, it is estimated that the Tashguzar-Boysun-Kumkurgon railway line in Uzbekistan raised subregional output by about 2 per cent through enhanced connectivity effects. This development appears to have been driven by value-added increases in industry and services of about 5 per cent and 7 per cent, respectively.<sup>2</sup>

### Services sector reform

Services reforms are complex because they involve a balanced mix of liberalization through deregulation, and reregulation. In particular, deregulation involves dismantling regulatory barriers to market entry and promoting competition, while reregulation includes the establishment of a transparent, predictable and enforceable legal environment, with strengthened and independent regulatory agencies. For countries that emerged from centralized planning systems, the policy challenge is even more complex as there are more regulatory barriers to dismantle and no benchmarks for effective regulation. In other words, the subregion is faced with the need to enhance competitiveness by increasing the contestability of markets through the entry of new domestic and foreign services providers. At the same time, it needs to implement effective regulatory supervision of both domestic and foreign operators due to the asymmetric nature of information in such systems.

Figure 1. Share of sector in GDP by country



Source: World Bank

Furthermore, reforms may – and often do – include privatization because State-owned enterprises still account for a large share of producer services in the subregion. Privatization is, however, not an essential condition. The incumbent service provider can remain State owned, as long as the regulator permits entry of new providers in the market in a non-discriminatory way that promotes competition. In this regard, foreign direct investment is an important channel through which foreign providers can contest infrastructure and other service markets as greenfield investments, joint ventures between public-private enterprises or other forms of privatization.

A key policy consideration is to identify what services the Government needs to provide and what can be left to private initiative. Kyrgyzstan’s nascent participation in regional value chains in clothing and beans is an example. Suppliers of specialized services have emerged in response to demand. The Government’s essential role was limited to providing transport and communications infrastructure services and to facilitating international trade.

Government support can also involve positive externalities. For example, as the largest economic centre of Kazakhstan, Almaty’s 2020 Development Plan foresees the conversion of the city into an international transport and logistics hub. This involves the construction of a world-class airport, new road junctions and main transport routes (including connections with the main Western China to Europe route), as well as the development of accompanying logistics services. The Almaty Plan also places emphasis on the ease of doing business. It aims to increase the share of foreign investments to fixed assets by 50 per cent by 2020 and will use this measure as an indicator of the city’s ability to independently attract foreign investors, including multinational companies. Towards this end, it is opening up a “one stop” business service for investors that will streamline and speed up the time spent between application, approval and start of implementation of investment projects.

Such developments could also stimulate domestic firms to participate in global value chains because many initiatives necessary for the creation of modern hubs, such as effective internet connectivity and

courier services, are also prerequisites for value-chain participation. The act of internationalization of a city could itself spur new service activities as people bring in new ideas on how to remove bottlenecks or increase efficiency. An important spin-off benefit could include improved public support for provision of education and health services. While Kazakhstan, as is the case for other countries in the subregion, inherited high literacy rates and basic health services from the centrally planned economy, it has been a long and difficult task to maintain past achievements as well as create education and health services able to meet the needs of a modern market-based economy.

## Progress so far and ways forward

Recent policy reforms have shown some early results. According to the World Bank’s ease of doing business index,<sup>3</sup> notable improvements were made in the overall business environment between 2014 and 2015 (see table 1 below).

Table 1. Rankings by Ease of Doing Business and Logistics Performance Index

	DB Overall Ranking		DB Trading Across Borders		LPI
	2014	2015	2014	2015	2014
Armenia	45	35	110	29	92
Azerbaijan	80	63	166	40	125
Georgia	15	24	33	78	116
Kazakhstan	77	41	185	122	88
Kyrgyzstan	102	67	183	83	149
Russian Federation	65	51	155	170	90
Tajikistan	143	166	188	132	114
Turkmenistan	n.a.	n.a.	n.a.	n.a.	140
Uzbekistan	146	141	189	159	129

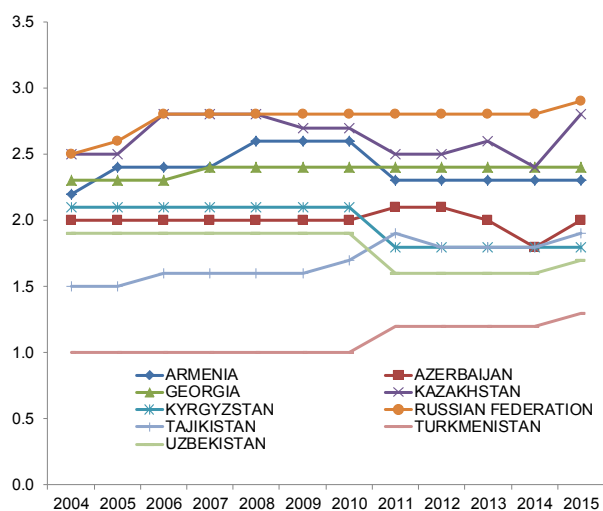
Source: World Bank Doing Business. Available from [www.doingbusiness.org/rankings](http://www.doingbusiness.org/rankings) and LPI <http://lpi.worldbank.org/international/global/2014>.

Of the 10 components that make up the index, the improvements are largely attributable to the “ease of trading across borders” component in Armenia, Azerbaijan and four Central Asian countries for

which data are available. Georgia maintained its position above the median, while the other countries remained below the median, despite the improvements made in cross-border trading.

Another relevant indicator is the services reform index of the European Bank for Reconstruction and Development (see figure 2), which is used to measure progress in policy reform in the services sector. That index reflects the average of three sub-indices, namely banking, non-banking and infrastructure reforms.

Figure 2. EBRD Services Reform Index



Source: European Bank for Reconstruction and Development.

For recent World Trade Organization (WTO) entrants, the index shows a slight improvement in Tajikistan, primarily due to improvements in the non-banking sectors prior to the country's WTO accession in 2013. For the other two WTO entrants, Kazakhstan and the Russian Federation, although at higher levels than Tajikistan, the index shows a more stable trend, and thus suggests slower progress over the past decade.

In looking forward, it is not unreasonable to expect positive developments in the reform agenda to emerge over the next five years, as the economic slowdown continues to expose the weaknesses of an undiversified economic structure. In this regard, service sector commitments under the General Agreement on Trade in Services can serve as a means of locking in and reinforcing domestic policy reforms that will promote an economic structure that is more resilient to global economic volatility.

The time is opportune for conducting in-depth studies that are adapted to the realities and idiosyncratic challenges of the subregion. There is a need for policy advice that identifies and sequences priority sectors for a services liberalization agenda. More research is needed to identify precisely which service inputs are important for enhancing the competitiveness of exports and how countries in the subregion can bolster such inputs. This could involve policies for promoting and facilitating foreign direct investment in strategic sectors, subcontracting arrangements and investments in social services that would build a skilled workforce. Policy advice is also needed concerning measures that would tackle regulatory barriers while introducing new regulations that would enhance the conditions for competition so that a higher content of services in the downstream economy could be realized for economic diversification.

<sup>1</sup> See Fernandes, Ana M., "Structure and performance of the services sector in transition economies". Policy Research Working Paper, No. 4357. (Washington, D.C.: World Bank, 2007). Available from <http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-4357>

<sup>2</sup> See Yoshino, Naoyuki and Umid Abidhadjaev. "An impact evaluation of investment in infrastructure: the case of the railway connection in Uzbekistan". ADBI Working Paper Series No. 548 (Tokyo: Asian Development Bank Institute, 2015). Available from [www.adb.org/publications/impact-evaluation-investment-infrastructure-case-railway-connection-uzbekistan](http://www.adb.org/publications/impact-evaluation-investment-infrastructure-case-railway-connection-uzbekistan).

<sup>3</sup> For rankings under the Doing Business project, see [www.doingbusiness.org/rankings](http://www.doingbusiness.org/rankings) and <http://data.worldbank.org/indicator/IC.BUS.EASE.XQ>.

The MPFD Policy Briefs aim at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. This issue is prepared by Richard Pomfret of the University of Adelaide and Tiziana Bonapace of ESCAP Subregional Office for North and Central Asia (SONCA). This policy brief, which is also published as SONCA Information Brief, benefitted from inputs by Hong Pum Chung and comments by Steve Gui-Diby, Hamza Ali Malik and Vatcharin Sirimaneetham. For further information on this issue, please contact Aynul Hasan, Director, Macroeconomic Policy and Financing for Development Division, ESCAP ([escap-mpdd@un.org](mailto:escap-mpdd@un.org)).