DAVID DOLLAR: Hi, I'm David Dollar, host of the Brookings trade podcast Dollar & Sense. Today, my guest is my colleague Josh Meltzer, a senior fellow in the Global Economy and Development program at Brookings. Brookings has put out a large number of studies this year under the rubric of Global China. Josh has a paper in this series that just came out and is available on the Brookings website. The paper is titled “China's Digital Services Trade and Data Governance: How should the United States respond?” That will be our topic today. Welcome to the show, Josh.

JOSHUA MELTZER: Pleasure to be here, David.

DOLLAR: Let's start with the basics. What specifically comprises digital services trade? I should know, but I'm only vaguely aware of what's actually involved. Can you give us a sense of its growing importance in international trade?

MELTZER: Sure. It can be thought of as more or less anything that can be delivered online and globally. But I also think it is important to point out that there are a couple of elements to this. Certainly, one is direct services provided online. You can think about this in terms of professional services, IT, telecommunications— the types of services that could be provided direct to another business or consumer over the Internet. Another important part of the digital services landscape is those digital services that are increasingly embodied as inputs into manufacturing. In that respect, you get a lot of digital services that are essentially exported as inputs in manufactured products. That's part of the broader phenomena of the so-called servicification of manufacturing— but focusing on the digital element.

So there's obviously then a global value chain component to digital services trade as well. In this respect, I think there are two elements. One is the digital services that just enable global value chains. Here you may think of ICT, for instance, and other digital communications services. Then there's also what is sometimes referred to as digital services which solve problems, which again would be in your professional services range: marketing, sales, and the types of services that could be provided online.

Once we account for both direct and the import side, or the value-added in manufacturing, the data tends to show that, at least when we think of services broadly, for many countries well over 50 percent of exports are in fact services. And we are seeing much faster growth in the services and digital services component when you take into account the value-added element— certainly faster than traditional trade in goods.

This is also a phenomenon which is happening across developed and developing countries. If you look at, for instance, Mexico, their gross services exports— the way traditionally services are accounted for— direct services are about 10 percent of total exports. But when you factor in the services in their value chains and manufacturing, it goes up over 3.5 times to about 35 percent of total exports.

Another important element here is that the input side underscores the importance of import. So in Mexico, about a third of their digital services actually come from overseas; they are imported and then consumed and used in value chains which are then input into further products for export. Similarly, if you look at India, you get very significant outcomes in terms of the importance of digital services in their total exports. In fact, once you take that into account and you look at services broadly as well, you get to well over 50 percent. So very significant.
DOLLAR: So this is quite important for helping us understand the reality of modern trade. We do tend to still think about trade mostly being manufactured products, and in a gross value sense that’s true, but as you’re pointing out a lot of the value added is coming from the service sectors. What that means is that a lot of the jobs involved in international trade— and a lot of the job creation— will be in these sectors as well. So your paper is specifically about China. Well, it's really about the world, but it has a focus on China. What are China’s strengths and weaknesses in this area of digital services trade?

MELTZER: There are many strengths, certainly. If you look first at the size of China's digital economy, it’s about the second largest globally. You have a lot of netizens, so-called netizens, online generating lots of data. Data is a core import into the digital economy broadly and into a lot of digital services. So when we think about e-commerce, digital payments, and certainly artificial intelligence, these are digital services and they rely on a lot of data which China has a lot of because it has a very engaged population online.

China is also dominant in a lot of the telecommunications equipment, particularly around 5G which there has been a lot of focus on lately. And 5G is itself is going to be very important, particularly as it gets rolled out and will become a key underpinning of the expansion of the Internet of Things.

China also, as you can imagine given their centrality in global value chains, has been exporting a lot of digital services through their manufactured products. In fact, the WTO estimates that services accounted for about 30 percent of the value of China's manufactured exports in 2015, which is about 20 percent growth over 10 years. So there is a lot of opportunity, I think, and strength for China on this front.

DOLLAR: One of the things I take away from your paper is that in addition to the strength of China that you just talked about, China is in some sense also the most protected economy in terms of these digital services. Among the G20 countries, for example, China stands out in terms of having relatively protected domestic markets. So what does that entail specifically, and how does that affect this issue?

MELTZER: Certainly China is a very closed market when it comes to digital services. There are two elements to this that I highlight in the paper. One is restrictions on the direct form of digital services as well as restrictions on data flows more generally into and out of China. The OECD has an index called the Digital Services Trade Restrictiveness Index which shows a range of barriers affecting trade and digitally-enabled services which they categorize into five policy areas: infrastructure, electronic transactions, payment systems, IPRs, and other barriers. China is essentially the highest on all of these metrics. On that basis you see significant digital services trade restrictiveness, and it really stands out globally how high that is.

In addition to this, you have a very regulated and restricted Internet. This is well understood. It includes significant restrictions on the ability to move data and information into and out of China. It includes extensive data localization requirements. All of these also restricts opportunities for digital services trade. A lot of these regulations are sort of focused around security: both Internet access and control as well as financial flows. So, for instance, China requires banks and insurers to localize data. They have very significant data localization requirements under their cybersecurity law as well. And in addition to this, you see a lot of regulations that require access to company
source code and IP under the guise of national security which act as disincentives to various forms of digital services trade with China.

**DOLLAR:** Let's shift the focus to the United States for a moment. The U.S. has been trying to ensure open digital services trade through trade agreements. That was a big part of the Trans-Pacific Partnership (TPP) where the U.S. was involved in the negotiations. In the end the U.S. dropped out, so it is not participating, but it took the digital services aspect of that agreement and brought it into the renewed NAFTA — the so-called USMCA agreement. I think the U.S. has brought it into the South Korea agreement as well. So, what are these provisions for cross-border services trade that the U.S. is trying to embed in trade agreements?

**MELTZER:** The U.S. has certainly been using trade policy, I think, as one of the key tools to try to support and underpin the open Internet and the freedom to move data flows globally — which is essentially how the Internet has been built — and to head off and constrain what we see as growing restrictions and regulations on data flows, particularly in China. As you mentioned, David, certainly the TPP — which is now the Comprehensive and Progressive TPP (CPTPP) which the Trump administration pulled out of in its first week of office but has nevertheless come into effect — has very robust commitments; as well as the recent USMCA and also the US-Japan Digital Trade Agreement. They all have a couple of key elements to them. There are a bunch which do touch on digital services, but the main ones I'll mentioned are commitments to cross-border information flows, commitments not to localize data as a condition for doing business and not to require access to source code. All of these are subject to exceptions which have been modeled around the GATS Article XIV exception provision. So it provides the opportunity for governments to essentially introduce those types of restrictions where they can be justified for legitimate public purpose and under various other elements that they have to establish under the exceptions provision.

I think importantly as well there is — particularly in the USMCA, but you see this also in the Japan digital trade agreement — there is a recognition and a push for interoperability. Particularly, you see a focus in the USMCA on the need for interoperability between privacy regimes. So the recognition that there's a range of legitimate reasons why governments may feel compelled to restrict cross-border data flows; privacy is often a key one. And you have governments pursuing different privacy regimes which creates incentives to restrict data flows because of concerns about personal data being trading in third countries. So these trade agreements are also being used to start to push for a conversation around how to essentially create bridges or interoperability between different privacy regimes and other regulatory regimes which would otherwise lead to barriers or restrictions on cross-border data flow.

This notion of interoperability was actually picked up by the Japanese in the Osaka G20. Osaka released a statement of data free flow with trust and I think it is another sort of useful framing of trying to build a broader data governance mechanism for allowing governments to achieve legitimate domestic regulatory objectives while minimizing barriers to data flows.

**DOLLAR:** The U.S. and China are the two biggest economies in the world, and we have talked a little bit about their approach. The European Union would be the other very large player in the world economy. How does the European Union fit into this US-China...let's call it competition rather than conflict over the approach to digital services trade? Does Europe have its own approach? Does it side with one of the other two? Where does Europe fit in?
MELTZER: Europe certainly is in some respects the third leg of that stool and absolutely a key player. To some extent it is carving out maybe a third way or a different position for itself. A lot of this is built around the GDPR— the privacy regulation which has some fairly stringent steps that need to be complied with in order to transfer European personal data outside of the EU. A recent Court of Justice decision has probably made that even harder.

The EU has also been engaging on this issue in the trade space, but with a slightly different take than the U.S. in large part because of GDPR. For instance, if you look at their recent FTA with Japan, they do have similar types of provisions that the U.S. put in its FTAs on not requiring access to source code. They also reflect what is already in the WTO on transfers of financial information when it is for the conduct of financial institutions or services, but they have not taken the larger and what the U.S. considers more important step of supporting commitments to cross-border data flows and no data localization. These are certainly not reflected in any of their most recent FTAs, for instance with Japan or Canada. Whereas Japan and Canada have themselves made those commitments in their FTAs with the U.S. So it is clear that the barrage of this is not those other parties but the EU.

If you look at what's been going on in the WTO, and at e-commerce negotiations which include the EU, United States, China, and other countries, the EU has in fact proposed some language on cross-border data flows. But they have included an extremely broad, essentially self-defined carve out or an exception which would, in many instances, kind of undermine the value of such a commitment. So there is certainly an important space between the U.S. and the EU on getting to common ground on this issue.

DOLLAR: Can I ask a follow up question on this issue of privacy? To me as a non-expert on this particular issue, it seems clear that my health data, my financial data, these are private things. But when we talk about data privacy, are we also talking about my shopping habits which are being monitored by various online platforms? How broad does this category of data privacy go?

MELTZER: Anything that makes you personally identifiable based on information collected online is certainly subject to privacy regulation. It depends which one we are talking about. In the U.S. there is a sectoral approach where your health data has specific levels of protection compared to the types of data you might reveal about yourself when you are on a commercial e-commerce website. The GDPR is not so sector-focused as it is sort of a broad common set of requirements whenever there is personal data provided online. And then when we talk about the cross-border data flow element, the GDPR has very specific mechanisms under which you can then transfer personal data to third countries. This has been the subject of a lot of litigation as well as attempts between the government here in the U.S. and the European Commission to find ways of enabling those data flows. The most recent mechanism, the Privacy Shield, was held to be invalid by the Court of Justice of the European Union. So now there is a lot of uncertainty around how personal data can continue to flow from the EU to the U.S.

DOLLAR: Obviously for our discussion it seems that China, the United States, the European Union, at least these three big players all have somewhat different approaches. Are there prospects for reaching some kind of compromise among the big three for a common approach? Something that could perhaps be codified in a WTO agreement? Alternatively, it seems to me there is a risk that we start creating alternative systems. Basically, a Chinese system, a U.S. system, perhaps a separate European system. That is going to create a lot of trouble, frankly, for the large number of small countries in the world that are not necessarily going to want to tie themselves to only one of
these three big economies. So, what are the prospects going forward for reaching some kind of compromise?

MELTZER: I concur entirely with your concern about what a bifurcated Internet, which would sort of accompany a different set of technology standards, would mean for trade for small countries as well as for small businesses. I don’t think things are looking good at the moment. Certainly the U.S.-China trade war broadly, which is very technology focused, has, I think, made cooperation on any of these issues very hard.

Again, if you look at the WTO e-commerce negotiations, the Chinese are sort of narrowly focused on e-commerce, goods, and some of the enabling services whereas the U.S. takes a much broader focus on digital trade and all the data-related aspects, including the dataflow pieces. And as I mentioned, the EU and the U.S. can’t even align on a common approach in the WTO, so making progress there, I think, will continue to be difficult. There is also a lot happening in the standard space which risks becoming another point of divergence between the West broadly and China. So the trends, I think, unfortunately, are towards increasing divergence and bifurcation, but the costs as you mentioned will be significant.

DOLLAR: So last question, Josh, is what the U.S. should be doing. We’ve touched on the U.S. approach of trying to incorporate relative openness in trade agreements. Aside from trade agreements, what should the United States be doing on this issue?

MELTZER: It’s a big landscape, so I’ll just mention a couple of key areas that I think are important. Certainly on the standards front: this is increasingly a place where many of the underlying developments that are going to impact the next wave of technologies—certainly AI, for instance, but also autonomous vehicles—are going to be developed. China is putting a huge focus on developing standards consistent with its model of governance in these bodies. So it is engaging at the government level. Huawei is a big player in relevant standard-setting bodies around 5G. There is a lot of government support for participation of experts. So while the U.S. certainly engages, and U.S. companies are very engaged in these bodies, I think that we need a much more focused and probably strategic approach to how standards are being developed in this place. This also requires much better coordination with the EU where possible and other like-minded countries.

The other area where I think the U.S. needs to do more work is just frankly on the domestic regulation front. The U.S. has had, I think, a very well-designed bottom-up kind of iterative approach to standards development domestically. It has been very stakeholder-driven. It has provided a lot of space for experimentation and avoided standards becoming overly burdensome. So I don’t want to upset that apple cart unnecessarily. But increasingly, back to your point about the bifurcation of the Internet, we have China in particular but to some extent the EU as well with very developed top-down regulatory models that other countries are increasingly looking to emulate. The lack of any sort of alternative model which can help governments navigate how they achieve legitimate domestic regulatory objectives like privacy and benefit from the digital economy, including digital services, I think prevents the U.S. from playing the kind of leadership role that it can and should play. But in order to do that, I think the U.S. needs to be a bit more comprehensive in getting some federal regulation on the books, particularly around privacy as a starting point, in order to actually be a bigger player in that game globally.

Broadly speaking, one of the elements that comes out from a lot of this is also the normative elements of what’s actually going to be important here. When you think about appropriate models
ultimately around digital services and access to data and information, we're talking about having to build trust in the global Internet and a system that's consistent with values around openness and nondiscrimination. Artificial intelligence—there is a lot of discussion around ethical AI. Some think the U.S. should be playing a big role here, and it is beginning to, but again other countries are thinking about this very strategically as well.

This also requires a more strategic and consistent level of outreach with other like-minded countries. That would be countries with common democratic sort of foundations which would obviously be places like the EU and Japan and Australia and others. It also requires, I think, slightly more coordination domestically. There are a lot of government agencies engaged around digital and data flows and standards and AI. There is coordination, but I think a more articulated strategy of what the U.S. is going to do around some of these core future-looking digital services and how that's going to actually be put into place—both in terms of R&D and regulation—would be a very positive development in terms of ensuring the U.S. remains the key developer and innovator on a lot of these technologies going forward and also that it can play the type of role that it should be playing internationally.

DOLLAR: I’m David Dollar and I’ve been talking to my colleague Josh Meltzer from the Global Development group at Brookings. His new paper is “China's Digital Services Trade and Data Governance: How should the United States respond?” available on the Brookings website. Thanks a lot for sharing your insights, Josh.

MELTZER: Pleasure, David. Thanks a lot for having me.

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