

THE ROLE OF TRADE LIBERALIZATION IN SERVICES IN DEVELOPING COUNTRIES

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Abstract

The services sector is the most important sector for most developing countries. It is the largest contributor to economic growth and employment. Trade in services is a rapidly growing phenomenon. International trade in services can improve economic performance but services liberalization also carries some risks. The objective of this paper is to examine the role of trade liberalization in services in terms of economic growth and comparative advantages in developing economies.

Key Words: Trade in Services, Developing Countries

GELİŞEN ÜLKELERDE HİZMETLER TİCARETİNİN SERBESTLEŞMESİNİN ROLÜ

Özet

Hizmetler sektörü, pekçok gelişen ülke için en önemli sektörlerden biridir. Büyüme ve istihdam hizmetler sektörünün en önemli katkısıdır. Hizmetler ticaretinde serbestleşme, hızla gelişen bir olgudur. Hizmetler ticaretinin serbestleşmesi ekonomik performansı artırabilir ancak bazı riskler de taşıyabilmektedir. Bu çalışmanın amacı gelişen ülkelerde hizmetler ticaretinin serbestleşmesinin rolünü ekonomik büyüme ve karşılaştırmalı üstünlükler açısından incelemektir.

Anahtar Kelimeler: Hizmetler Ticareti, Gelişen Ülkeler

1.Introduction

International trade in services play a major role in all modern economies. An efficient services sector is critical to economic growth and to vibrant and

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resilient economies. Trade in services creates wealth and jobs for all economies around the world, and is a catalyst for development. Services are the backbone of economies and trade around the world and provide vital support to the economy and industry as a whole, for example through finance, logistics and communications. Increased trade in and availability of services will boost economic growth, business growth and development by improving the performance of other industries, since services provide key intermediate inputs, especially in an increasingly interlinked globalised world¹.

The aim of the article is to examine the role of trade liberalization in services in developing countries. First, the article begins with an overview of international trade in services. Second, the article gives the contribution of trade liberalization of services. Next, the article investigates economic growth and comparative advantage in services in terms of trade liberalization in services. Finally, the article provides a conclusion.

2. An Overview of International Trade in Services

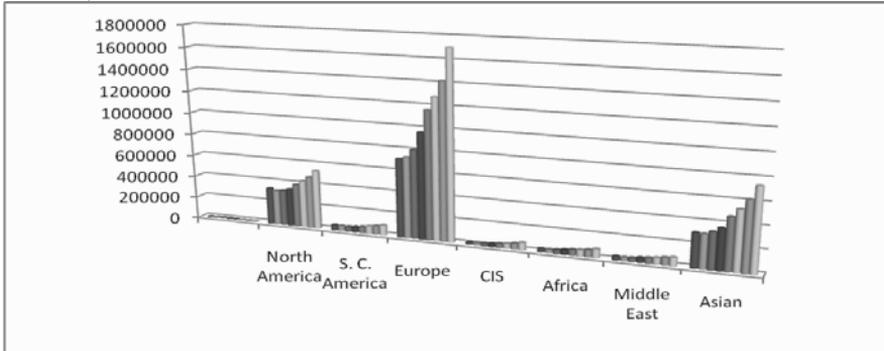
The role of services has changed dramatically in recent decades. Services represent the largest single sector in developed economies and increasingly in developing economies as well, accounting for nearly two-thirds of value-added and employment in the developed economies and about half in the developing economies. Services are also the fastest-growing component of international trade².

The value of trade in commercial services increased at a faster rate (18 per cent) than trade in goods (15 per cent) in last decade. This was mainly due to the expanding international supply of many services and to the increase in transportation prices. While the services sector generates approximately two-thirds of the total world value added, its share in total trade remains below 19 per cent. Trade in commercial services in 2007 was highly concentrated in Europe, Asia and North America. Trade within the European Union represented more than one-quarter of world trade. Other regions-especially the Commonwealth of Independent States (CIS), Africa and Middle East- have increased their share in commercial services. Although CIS has the smallest share in terms of world trade (2.5 per cent), the CIS has experienced an increase its share in commercial services since 2000 (Graph 1).

¹ Mushtaq Hussein and Bernd Schweinberger, **Economy and Finance External Trade**, eurostat, 14/2009,p.1.

²Alexander Lehmann, Natalia Tamirisa and Jaroslaw Wieczorek, 'International Trade in Services: Implications for the IMF', **IMF Discussion Paper**, PDP/03/6, December 2003, p.2.

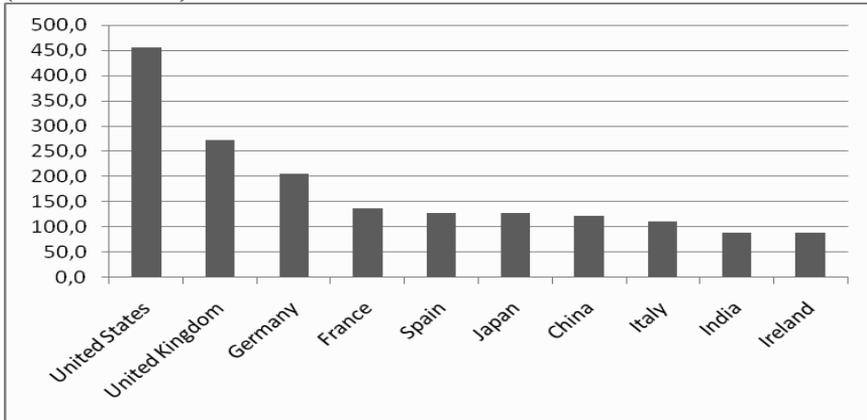
Graph 1. World Exports of Commercial Services by Region, 2000-2007 (Million Dollars)



Source: WTO, International Trade Statistics, 2008.

In 2007, the major exporters of commercial services remained the European Union, the United States, Japan, China and India, which together represents just under two-thirds of world exports. In recent years, China and India's exports of commercial services have increased much faster than the world average (Graph 2).

Graph 2. Leading Exporters in World Trade in Commercial Services, 2007 (Billion Dollars)



Source: WTO, International Trade Statistics, 2008.

Looking at the different categories of services between 2002 and 2007, travel as a share of total services decreased by 4 percentage points, down to 24% in 2007. Although tourism continues to be a flourishing sector, the share of travel in world exports of services has declined steadily in recent years owing to the boom in trade in other services. The share of other services increased by 2 percentage points (up to 51%). The share of transportation services also increased from 23% to 25% (see

Graph 3). Rising fuel prices and the inability of some major shipping routes to meet demand continued to have a significant effect on transportation costs³.

Graph 3. Breakdown of Total World Trade in Services, in %



Source: IMF Balance of Payments Statistics, 2007.

3. The Contribution of Services to Development

The services sector makes a key contribution to gross domestic product (GDP) and employment in most developing countries. It also provides essential inputs and public services for the economy. International trade in services can also improve economic performance and provide a range of traditional and new export opportunities. The services sector often accounts for over 50 % of GDP in low income countries, while the process of development usually coincides with a growing role of services in the economy. Therefore services constitute an increasing percentage of GDP in nearly all developing countries. In addition, employment is shifting out of agriculture and into services, and the services sector accounts for more than half of all employment in many countries. This employment can be relatively unskilled, such as in tourism and retail sectors, thus benefiting the poor in particular. Financial services, tourism, distribution, health and education are all important sectors for developing countries, in terms of their contribution to GDP and/or employment⁴.

Many services are key inputs to many other businesses. These include infrastructure services such as energy, telecommunications and transportation; financial services that facilitate transactions and provide access to finance for investment; health and education services that contribute to a fit, well-trained workforce; and legal and accountancy services that are part of the institutional framework required to run a healthy market economy. Not only are services important for the economy, but they also have a direct impact on social

³ Hussein and Schweinberger, p.2.

⁴ Massimiliano Cali, Karen Ellis and Dirk Willem te Velde “ The Contribution of Services to development: The role of regulation and trade liberalization” Overseas Development Institute, Project Briefing, No. 17, December 2008, p.1.

development, providing health and education services⁵. Following part will give the potential benefits and risks of trade liberalization of services.

3.1 Potential Benefits of Trade Liberalisation of Services

Trade in services has important implications for the balance of payments. Many developing countries have benefited from exports of construction, banking, and professional services or from services transactions based on telecommunications networks. Remittances from nationals residing abroad and the compensation of residents temporarily employed abroad represent important currency revenues, in some countries rivaling export receipts. Furthermore, international services trade has important implications for capital flows. Recent estimates suggest that nearly 60 percent of international services transactions are conducted through foreign affiliates of multinational companies. Already, nearly one-half of the total outward FDI stock of OECD economies is in services sectors⁶.

Many developing countries have already liberalised many service sectors quite considerably while the degree of liberalisation varies by sector and country. Trade in services can help create opportunities for countries to expand their outputs of services in sectors where they have a comparative advantage, thus creating jobs and contributing more to GDP and generating foreign exchange. Therefore, service exports can be an important part of a developing country's growth strategy. Most imports of services are brought about through FDI, they can also bring much-needed capital into the country. They can help to stimulate investment in infrastructure development⁷.

Liberalizing international trade in services is likely to yield substantial gains in welfare and by reducing the margin between the prices of foreign and domestic services, a country will increase national welfare, in a way comparable to the liberalization of goods trade. Because many services are intermediate inputs in the production of goods and other services, this can be compared to a reduction of a tax on downstream sectors. Few barriers to services trade are price-based, and hence liberalization rarely entails a loss in fiscal revenue. Adverse terms of trade effects are also unlikely for small countries. Additional benefits could derive from factor movements that result from market access commitments for commercial establishments or the temporary movement of natural persons⁸.

Recent empirical studies indeed substantiate these potential gains, in particular in developing countries. One study suggests that open financial and telecom sectors may increase growth rates by up to 1.5 percent⁹. Global welfare effects from a services liberalization have been estimated to be on a par with those

⁵ Cali, Ellis and Velde, p. 2.

⁶ Lehmann, Tamirisa and Wieczorek, p.3.

⁷ Cali, Ellis and Velde p. 2.

⁸ Lehmann, Tamirisa and Wieczorek, p.10

⁹Mattoo, Aaditya, Randeep Rathindran, and Arvind Subramanian, "Measuring Services Trade Liberalization and its Impact on Growth: An Illustration," World Bank Policy Research Paper No. 2566, 2001, Washington: World Bank, p.1.

from a complete elimination of trade barriers in manufactures and agricultural goods. Such gains are intuitive, given the pervasive role of services in both developed and developing countries, and the comparatively high barriers to international trade. For developing countries, welfare gains were estimated to be two to three times larger in proportion to national incomes than in industrialized countries¹⁰. In addition, a general equilibrium model of Tunisia suggests that the liberalization of a number of key services sectors (telecommunications, construction, transportation, business and insurance, distribution and finance) could yield gains equivalent to 7% of GDP¹¹.

3.2 Potential Risks of Trade Liberalization of Services

Service trade liberalisation also carries risks and potential costs, and that government intervention to regulate the market is crucial if the benefits of service liberalisation are to be realised. A common argument has been that allowing foreign providers into the market may crowd out domestic providers, and instead allow foreign firms and shareholders to capture the profits for themselves, taking the money out of the country. While it is possible that foreign providers will out-compete the weakest domestic providers, perhaps as a result of greater efficiency or the use of more sophisticated technologies, the evidence also shows that foreign firms can improve the performance of domestic firms, by stimulating competition and by exposing them to superior business practices from which they can learn¹².

Service trade liberalization can carry financial sector instability. The recent global financial crisis highlights the risks associated with financial sector openness, as integration into world financial markets can increase vulnerability to contagion. There is evidence to show that the presence of foreign banks actually improves financial stability and reduces the likelihood of banking crises, on average, over the long term. But it seems likely that developing countries that have been more dependent on foreign lending will be hit harder by the current financial crisis than countries that had a more closed financial sector. It is now recognized that, although financial sector liberalization can be very beneficial in the longer term, it needs to be undertaken in a carefully sequenced manner, with a stable macroeconomic framework, adequate financial supervision, and regulation and privatization now seen as prerequisites that are crucial to minimize associated risks. Brain risk can be another risk in services. The temporary movement of persons to provide a service can exacerbate skills shortages in developing countries. This is particularly problematic when education and training of these individuals is partly funded by public revenue, some benefits of which will then accrue to developed countries. The risk of brain drain has been most widely recognized in the health sector. Trade liberalization of services can also carry the risk of environmental degradation. Especially, poorly managed tourism could lead to deforestation and erosion;

¹⁰ Lehmann, Tamirisa and Wieczorek, p.11.

¹¹ OECD, GATS: The Case for Open Services Markets, 2002, Paris.p.25.

¹² Cali, Ellis and Velde, p. 2.

degradation and depletion of biological diversity; disruption of natural habitats; and over-consumption of resources like freshwater and energy¹³.

Another concern relates to the impact on poverty. Opening domestic service sectors to foreign competition, for instance through privatization, may of course raise prices. Liberalization of individual services sectors may hence have a substantial adverse impact on household expenditures, in particular in areas such as utilities or infrastructure. The local establishment of foreign services providers also displace unskilled labor, or put at risk the universal provision of utility services. Mitigating these risks requires careful sequencing and pacing of services liberalization, particularly in relation to broader regulatory, fiscal, and social reforms¹⁴.

Barriers to trade in services may both increase the costs and enable already established enterprises to capitalize on limited competition. When barriers to trade in services are reduced, both prices and costs will be affected. Increased competition from foreign enterprises will mean that established enterprises may have to reduce their prices. This results in a smaller price wedge between the producers' prices and costs, leading to allocation gains and lower prices. It will benefit consumers, but implies lower profits for established enterprises. Furthermore, lower costs mean increased productivity, as the production requires fewer resources. Productivity increases will enable higher value added and lower prices, which will generate profits. These profits will be distributed as higher wages and salaries, higher return on capital and lower consumer prices. Some jobs will disappear due to higher work productivity, but increased demand and higher expenses will, by contrast, stimulate employment as lower prices and higher consumption will stimulate demand in the entire economy. Increased demand implies that production grows, which will compensate for the jobs that are lost due to increased work productivity. On the whole, total employment and welfare effects will vary in different sectors and countries depending on economic structures, trade patterns and on how much the barriers are reduced¹⁵.

4. Economic Growth and Comparative Advantage in Service

There is increasing evidence that services liberalization is a major potential source of welfare gain, and that the performance of service sectors, and thus services policies, may be an important determinant of trade volumes, the distributional effects of trade, and economy-wide growth. In the following part, firstly, it is given the effect of trade liberalization on economic growth, secondly, it is analyzed the comparative advantage in developing countries.

¹³ Cali, Ellis and Velde, p. 3.

¹⁴ Lehmann, Tamirisa and Wieczorek, p.12.

¹⁵ Copenhagen Economics, "The Copenhagen Economics Trade Model", Technical Working Paper, 2005. in National Agency for Enterprise and Construction, 'Economic Effect of Liberalising International Trade in Services, December, 2005. p.14.

4.1 Trade Liberalization in Service and Economic Growth

An important economic characteristic of many services is their “facilitating” role: services support ever-finer specialization¹⁶. Especially, Francois discusses that the growth of intermediation services is an important determinant of overall economic growth and development. Most of this intermediation activity facilitates transactions in transport and telecom¹⁷. Many empirical studies have investigated the linkages between services liberalization and economic growth. Matto, Rathindran and Subramanian find that controlling for other determinants of growth, countries with open financial and telecommunications sectors grew about 1 percentage point faster than other countries. Full liberalizing both the telecommunications and the financial services sectors was associated with an average growth rate 1.5 percentage points above that of other countries¹⁸. Eschenbach and Hoekman utilize three indicators of the “quality” of policy in banking, non-bank financial services and infrastructure including liberalization, on economic performance for a sample of 20 transition economies. They find that changes in policies towards financial and infrastructure services, including telecommunications, power and transport, are highly correlated with inward FDI¹⁹.

In addition, Arnold, Javorcik and Mattoo analyze the effects of allowing foreign providers greater access to services industries on the productivity of manufacturing industries relying on services inputs. The results show a positive relationship between FDI in services and the performance of domestic firms in manufacturing²⁰. Arnold, Mattoo and Narciso also find a statistically significant positive relationship between firm performance and the performance of three service input industries (communications, electricity and financial services)²¹.

Konan and Maskus use a computable general equilibrium (CGE) model to investigate the potential effects of removing barriers to trade services in Tunisia. They argue that increasing international competition on service markets will reduce the “cartel effect”. They conclude that removing policies that increase costs can have much greater positive effects on national welfare than the removal of merchandise trade barriers. Introducing greater competition on services markets that removes cost

¹⁶ Bernard Hoekman, ‘Liberalizing Trade in Services: A Survey’, **Working Paper 4030**, October 2006,1-62, p.21.

¹⁷ Joseph Francois, ‘Producer Services, Scale and The Division of Labor’, **Oxford Economic Papers**, 1990, 42: 715-29. p.726.

¹⁸ Mattoo, Aaditya, Randeep Rathindran and Arvind Subramanian, “Measuring Services Trade Liberalization and its Impact on Economic Growth: An Illustration,” **Journal of Economic Integration**,2006, 21:64-98. p.65.

¹⁹ Eschenbach, Felix and Bernard Hoekman. “Services Policy Reform and Economic Growth in Transition Economies, 1990-2004,” **Review of World Economics**, 3663,2006.

²⁰ Arnold, Jens Matthias, Beata Javorcik and Aaditya Mattoo, “The productivity effects of services liberalization: Evidence from the Czech Republic,” **World Bank**, 2006. p.11.

²¹ Arnold, Jens Matthias, Aaditya Mattoo and Gaia Narciso. “Services inputs and firm productivity in Sub-Saharan Africa: Evidence from firm-level data,” *Journal of African Economies*, 2008, 17: pp.578-599.p. 594.

inefficiencies raises the gains to 6-8 percent.²² Rutherford, Tarr and Shepotylo conclude that in the medium term virtually all households would gain from liberalization, with increases in real incomes in the range of 2 to 25 percent of base year household income in Russia²³.

4.2 Comparative Advantage of Developing Countries in Service

The principle of comparative advantage is the fundamental analytical explanation of the gains from trade. The laws of comparative advantage were initially formulated to explain patterns of trade in tangible goods. Theories explaining trade in goods can be divided into two categories. First, in a perfect competition, constant returns to scale framework, trade flows are induced by comparative advantage arising from (i) international differences in technologies (Ricardian model), (ii) international differences in relative factor endowments (H-O model), and (iii) international differences in tastes and preferences (Linder hypothesis). Secondly, trade can also arise when countries are identical, but only when comparative advantage is due to a context of increasing returns to scale and imperfect competition²⁴.

Several studies were undertaken to verify the applicability of traditional trade theories to services trade. Hindley and Smith²⁵, Deardoff²⁶, Sapir and Lutz²⁷ claim that these theories can be used to explain patterns of services trade. In principle then, the theory states that an economy should specialize in the production and export of services in which it has a relative advantage and import services in which it has a relative disadvantage. International trade on this basis will mean that services will be produced by the relatively least cost world producer and the quantity of services consumed will be optimal²⁸.

An economy may have abundant factor endowments of unskilled labour and a comparative advantage in labour-intensive services such as construction and

²² Konan, Denise and Keith Maskus. 2006. "Quantifying the Impact of Services Liberalization in a Developing Country," **Journal of Development Economics**, 81: 142-62.p.142.

²³ Rutherford, Thomas, David Tarr and Oleksandr Shepotylo, "The Impact of WTO Accession and the DDA: The Importance of Liberalization of Barriers Against FDI in Services for Growth and Poverty Reduction," in Thomas Hertel and L. Alan Winters (eds.), **Poverty and the WTO**, Palgrave and World Bank, 2006, 467-96.p.490.

²⁴ D. Van Welsum, International Trade in Services: Issues and Concepts, Birkbeck College London, September 2003.

²⁵ B. Hindley, A. Smith, 'Comparative Advantage and Trade in Services', **The World Economy**, 7/1984, pp.369-390. p.369.

²⁶ A.V. Deardorff, Comparative Advantage and International Trade and Investment in Services, In: **Trade and Investment in Services: Canada/US Perspectives**, (ed. R. M. Stern), Ontario Economic Council, Toronto 1985.

²⁷ A. Sapir, E. Lutz, 'Trade in Services: Economic Determinants and Development Related Issues', **World Bank Staff Working Paper**, No. 480, World Bank, Washington DC. 1981.

²⁸ Greg McGuire, "Trade in Services-Market Access Opportunities and the Benefits of Liberalization for the Developing Economies", **UNCTAD, Policy Issues in International Trade and Commodities Study Series** No.19, 2002, p.4.

tourism services. On the other hand, an economy may have a small quantity of highly skilled labour such that it has a comparative advantage in legal services. Developing economies clearly have a comparative advantage in labour services or services where labour is a major input, such as tourism. Some developing economies also have a comparative advantage in construction and transport services, although this is more variable between economies. New export opportunities are also emerging for developing economies in communications and computer services²⁹.

Following table³⁰ shows the export competitiveness of service export in developing countries in terms of factor intensive in different services- transport, travel, construction, communication, computer and information services, financial services, personal, cultural and recreational services. According to table, for example, Argentina has an export competitiveness of transport and travel in labour and resource category and of communication and financial services in skill and technology. In addition, Turkey has an export competitiveness of travel and transport in labour and resource intensive category and of communication in skill and technology category.

Table 1. Export Competitiveness of Service Export

Category of Services	Sector	Countries
Labour and Resource Intensive	Transport	Argentina, China Hong Kong, Egypt, India, Korea, Kuwait, Romania, Russia, Singapore, Thailand, Turkey, Ukraine
Labour and Resource Intensive	Travel	Argentina, China Mainland, Egypt, India, Malaysia, Mexico, Philippines, South Africa, Thailand, Turkey
Labour Intensive	Construction	China Mainland, Egypt, Malaysia Romania, Russia, Thailand, Turkey, Ukraine
Skill and Technology Intensive	Communications	Argentina, Brazil, Egypt, India, Indonesia, Philippines, Romania, Turkey, Ukraine
Skill and Technology Intensive	Computer and Information Services	Argentina, India, Romania
Skill and Technology Intensive	Financial Services	China Hong Kong, India, Singapore
Miscellaneous	Pers.Cul. Rec.Ser	Argentina, Egypt, Mexico, Rom. Turkey

²⁹ McGuire, p.4.

³⁰ Prabir De, International Trade in Services: Evolving Issues for Developing Countries, WTO/ESCAP/ARTneT, **Advanced Regional Seminar on Multilateral Negotiations in Services for Asian and Pasific Economies**, Kolkata, 19-21 September 2006, RIS, New Delhi.

5. Conclusion

The value of trade in commercial services increased at a faster rate than trade in goods in last decade. Services can be an engine of export growth for countries and international trade in services play a major role in all modern economies. The aim of the article is to examine the role of trade liberalization in services in terms of economic growth and comparative advantages in developing countries. Empirical studies have confirmed the positive effect of services liberalization on economic growth in developing countries. In addition, the developing countries have a comparative advantage which is resulted from factor endowments. Factor endowments of developing economies in services can vary among different service categories. The trade liberalization of services will continue to stay an important factor for developing economies.

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