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OIC OUTLOOK
REPORTS



Trade in Services and Role of Services Sector in Economic Transformation

OIC Outlook Report

No: 2018/1





OIC OUTLOOK REPORTS

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Trade in Services and Role of Services Sector in Economic Transformation

KENAN BAGCI, SESRIC

OIC Outlook Report

No: 2018/1

The Statistical, Economic and Social Research and Training
Centre for Islamic Countries (SESRIC)

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ABSTRACT / ملخص / Résumé

This report reviews the latest developments in services trade and analyses the structure of global and regional trade in services. It is found that OIC countries are not able account a good share of global trade in services as they fail to diversify their export base through creating an enabling environment. Moreover, they are losing their competitive advantages in many services sectors. Therefore, there is a need for building productive capacity and competitiveness in targeted services sectors through adequate national policies and regulations in OIC countries.

يعرض هذا التقرير آخر التطورات في تجارة الخدمات كما يقدم تحليلا لهيكل التجارة العالمية والإقليمية في الخدمات. وقد تبين أن بلدان منظمة التعاون الإسلامي لا يمكن أن تحقق نصيبا جيدا من التجارة العالمية في الخدمات لأنها تفشل في تنويع قاعدتها التصديرية من خلال خلق بيئة تمكينية. وعلاوة على ذلك، فهي تفقد مزاياها التنافسية في العديد من قطاعات الخدمات. ولهذا، هناك حاجة لبناء القدرة الإنتاجية والتنافسية في قطاعات الخدمات المستهدفة من خلال السياسات واللوائح الوطنية الملائمة في بلدان المنظمة.

Ce rapport examine les derniers développements dans le commerce des services et analyse la structure du commerce international et régional des services. Les pays de l'OIC ne sont pas en mesure de fournir une bonne part du commerce mondial des services car ils ne parviennent pas à diversifier leur base d'exportation en créant un environnement favorable. De plus, ils perdent leur avantage concurrentiel dans plusieurs secteurs des services. Il est donc nécessaire de renforcer la capacité productive et la compétitivité dans des secteurs de services cibles à travers des régulations et des politiques nationales adéquates dans les pays de l'OIC.



1 Introduction

Services sector play increasingly greater role in global economic activities. During 1980–2015, the share of services in GDP increased in all income level groups, including from 61% to 76% in developed economies and from 42% to 55% in developing economies (UNCTAD, 2017). OIC countries also experienced an increase of services sectors in total economic activities from 48% in 2000 to 53% in 2015 (SESRI, 2017).

Services comprise a diverse set of activities, including transport of goods and people, financial intermediation, communications, distribution, hotels and restaurants, education, health care, and construction. A well-functioning services sector implies better standards of living due to direct benefits to individuals as well as important contributions to overall economic performance. For example, financial sector development is associated with better allocation of capital, better risk sharing and more efficient distribution of savings to investment in an economy. Similarly, transport services contribute to a more efficient distribution of goods within a country and better education and health services are essential for overall productivity of the labour force.

In general, services constitute important direct inputs into the production of goods and services, and they are among critical determinants of the productivity of production factors. Therefore, it is generally argued that developing economies should have an effective policies and programmes for improving their services sector in order to initiate and sustain economic growth across other aspects of their economies.

It is however less evident that whether countries should prioritize services sector over manufacturing. Economic performances of countries are strongly associated with their ability to raise productivity levels across the economic sectors, but different sectors entail different characteristics in terms of contributing to overall productivity growths. It is widely believed that there is a need for structural transformation towards higher productivity sectors to achieve sustained growth and better economic performance. This implies that productive sources of an economy should move towards sectors that have higher productivity potential. Historically, economic activities in manufacturing sector have been linked to higher productivity growth compared to those in agriculture sector.

On the other hand, it is also argued that exportable business services today exhibit strong economies of scale and externalities and require relatively highly skilled labour, thus providing an opportunity for structural transformation even for developing economies (UNCTAD, 2014).





However, it is observed that services exports of developing countries concentrate heavily on tourism and transport sectors, which require relatively lower skilled labour.

This report reviews the latest developments in services trade and analyses the structure of global and regional trade in services. It also touches on the role of services in economic transformation. The report provides in depth analysis on the structure of trade in services in OIC countries by looking at the sectoral data. After discussing some general issues related to policies and agreements in services trade, the report concludes with policy recommendations.



2 Importance of Services Sector for Economic Performance

The process of modern economic growth has been historically accompanied by a structural transformation; or the reallocation of economic activity across three broad sectors (agriculture, industry, and services). Structural transformation is commonly measured by the changes in employment, value added and final consumption expenditure shares of three main economic activities. Economic growth has been typically associated with falling employment and value added shares of agriculture (Herrendorf et al., 2014). To a large extent, the fall in agriculture is offset by the rise in services, reflecting a post-industrial phase of development. Manufacturing sector witnessed an increase at lower levels of per capita income, reached a peak at medium levels of income, and then started to fall again.

Regional and global trends in the aggregate shares of economic sectors in total value added and employment since 1991 are depicted in Figure 1 and 2, respectively. Even in such a relatively short sample period for structural transformation analysis, we observe that share of agriculture in total value added has been constantly falling in developing countries, including OIC countries. It accounts already the lowest levels in developed countries with around 1.3% contribution to total value added. Globally, agriculture accounts 3.5% of global value added. In fact global distribution of value added across economic sectors do not change significantly since 1991, however there are divergent patterns across regions. The share of industry in OIC countries fell from 44.9% to 37.4% during 1991-2015, while it increased from 36.1% to 39.8% in non-OIC developing countries. The fall in agriculture and industry sector is offset by economic activities in services sector in OIC countries, which increased from 43.1% to 52.9% during the same period.

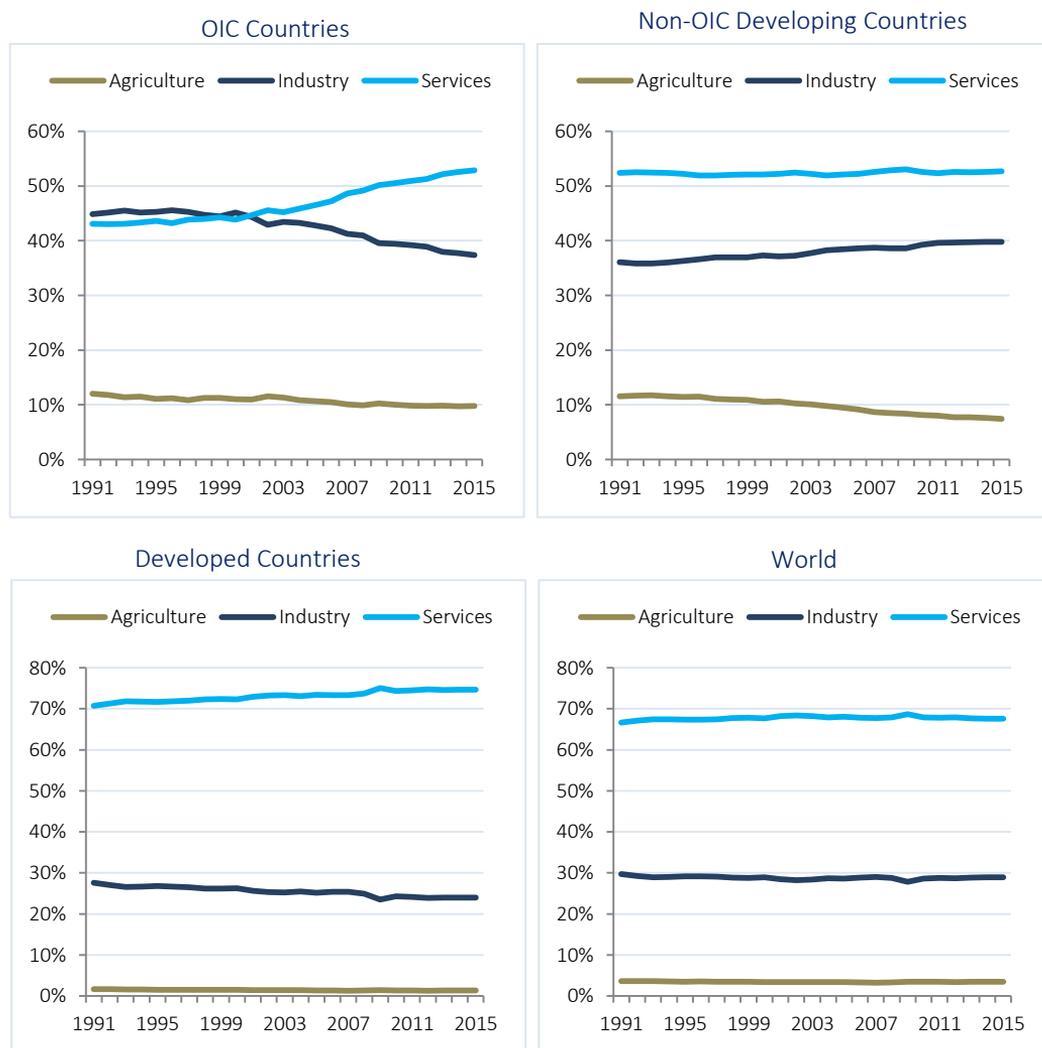
With respect to the distribution of employment across broad economic activities, there is a steady fall in the share of employment in agriculture. In the early stages of development, agriculture activities typically account for most of employment. The share of agriculture in employment declines, as countries develop. Globally, the share of agriculture in total employment fell from 42.9 in 1991 to 29.5% in 2015 and it's further expected to fall to 27.7% in 2020. The fall in agricultural employment is largely compensated with an increase in employment in services sector, while there is also slow increase the share of industry. Although the manufacturing sector increases its share, the services sector is the most dynamic in terms of employment creation.





A broad and robust domestic manufacturing base has been the key to successful economic development, since it helps generate productive linkages with other sectors of the economy, drives technological progress, and has the strongest potential for productivity improvements (UNCTAD, 2016a). It acts as the ‘learning centre’ of the economy and plays the leading role in diffusing technological progress (UNECA, 2016). The manufacturing sector also tends to be strongest driver for employment of wage workers, especially in developing countries (ILO, 2014). As highlighted in SESRIC (2017), a majority of working force in OIC countries are stuck in vulnerable jobs and most manufacturing jobs provide opportunities for more social security and more stable income flows. Moreover, manufacturing is where the technological progress takes place.

Figure 1: Share of Economic Sectors in Total Value Added (1991-2015)



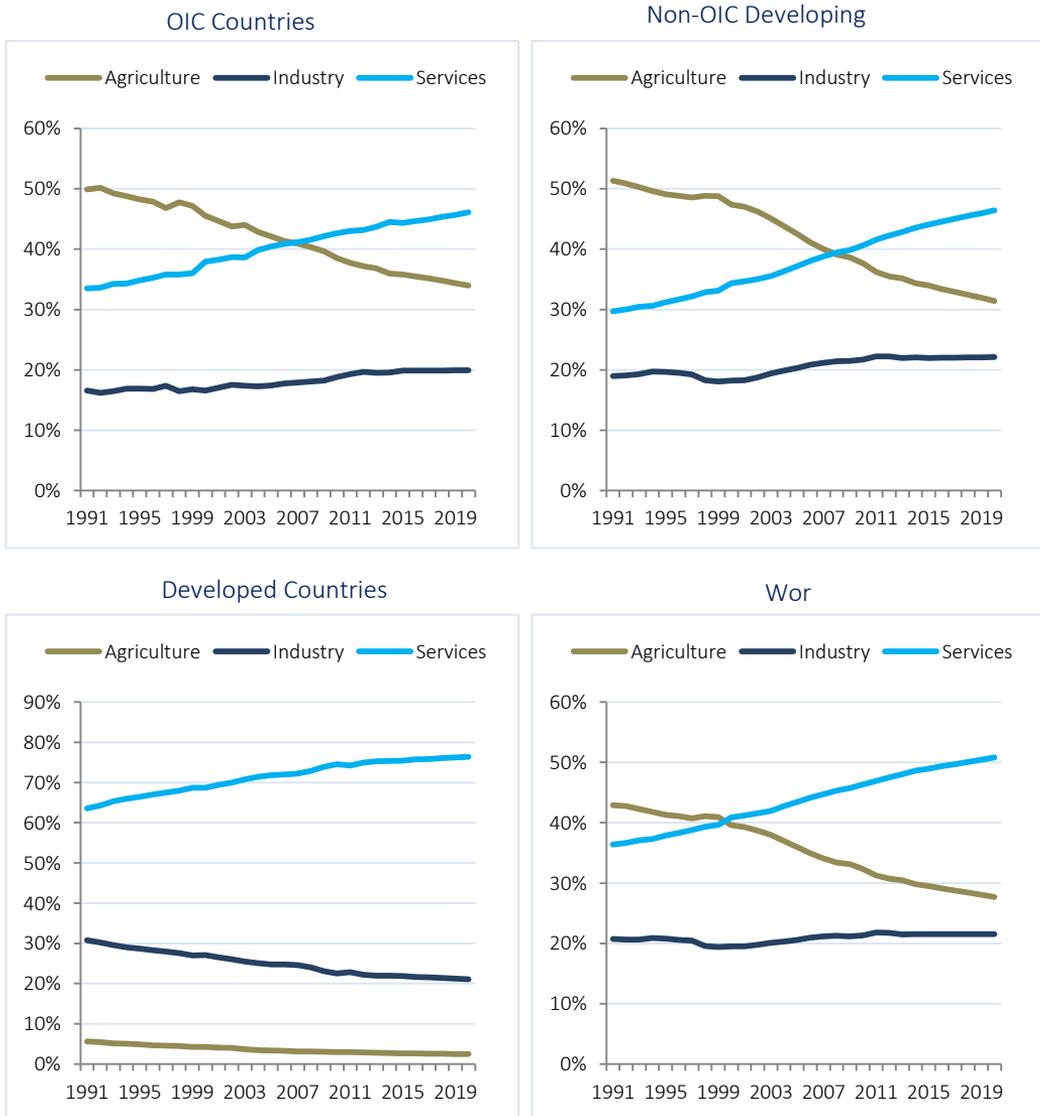
Source: SESRIC staff calculation based on UNSD National Accounts Main Aggregates database.





Learning and innovation may also take place in services and in some branches of agriculture, as they are becoming increasingly more capital intensive and knowledge based. However, it is again the manufacturing sector that produces a range of productive inputs for agriculture (e.g. chemicals, fertilisers, pesticides, and agricultural machinery) and services (e.g. transport equipment, computer technology, and mechanised warehouses) that help raise productivity in those sectors (UNECA, 2016).

Figure 2: Employment by Sector (1991-2020)



Source: SESRIC staff calculation based on ILO KILM (2000-2020) and WESO (1991-1999) databases. Data after 2015 reflects the projections of ILO.



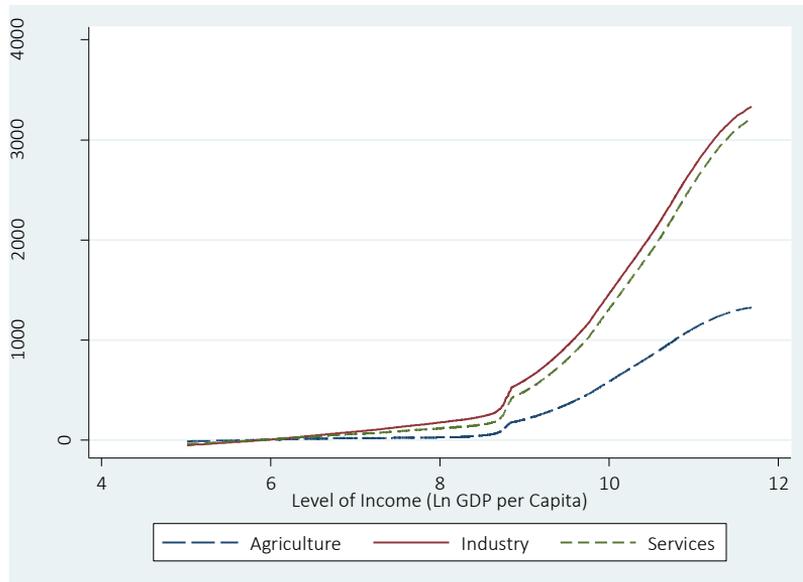


Evidently, the services sector increasingly dominates the economic structure of many countries in terms of output, employment and value added. In many developing countries, the growth of services, rather than manufacturing, has become a core strategy to diversify away from dependence of primary commodities. However, it is important to note that many services that have grown rapidly in the last few decades are heavily dependent on manufacturing firms, such as communications, banking, insurance, transport, design and engineering. Moreover, most services are characterised with low tradability. This means that countries that rely on their services sector for economic growth will eventually struggle with trade balance constraints (UNECA, 2016). Although services account for two-thirds of output in most developed economies, they still represent only around 20%–25% of international trade (HSBC, 2015).

2.1 Services and Productivity

As countries develop, different economic sectors have also different characteristics in terms of productivity. In services and industry, there are greater room for productivity improvements compare to agriculture sector. As shown in Figure 3, as countries become richer, productivity in services and industry grows more rapidly than agriculture sector. Similarly, as shown in Figure 4, productivity growths in different sectors follow completely different patterns after certain

Figure 3: Income Level and Productivity by Sector, 2005-2015



Source: Author's calculation using Lowess smoothing based on UNSD, ILO and World Bank databases.

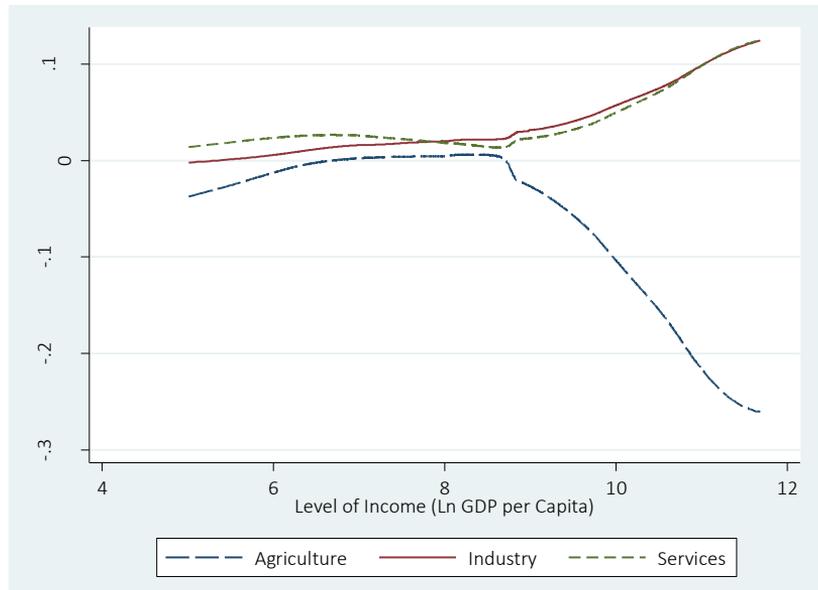
levels of income. This level is around USD 7,000 per capita. At low income levels, lack of adequate infrastructure and technology prevents the development of all sectors, especially manufacturing and services. These uneven constraints lead to diverse patterns of productivity growth in different sectors as these constraints ease at higher income levels.



Figure 5 shows the labour productivity in services sector in OIC countries as well as in non-OIC and developed countries for the period 1991-2015. Average productivity in OIC countries increased from USD 6200 in 1991 to USD 8700 in 2015. It increased from USD 5100 in 1991 to USD 7500 in 2015 in non-OIC developing

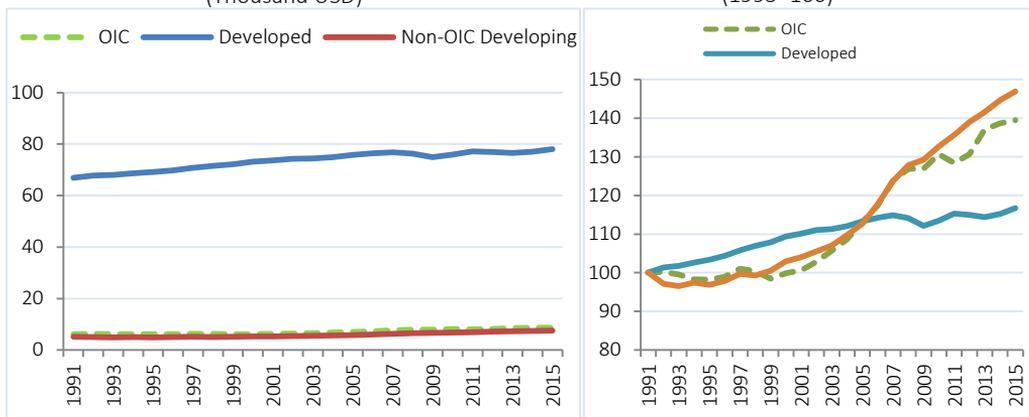
countries and from USD 66900 in 1991 to USD 78000 in 2015 in developed countries. Productivity growth was higher in developed countries until 2000, but then OIC and non-OIC developing countries started to achieve better performance in services sector productivity growth. Although this helps to narrow the gap between developed and developing countries, significant disparities remain.

Figure 4: Income Level and Productivity Growth by Sector, 2005-2015



Source: Author's calculation using Lowess smoothing based on UNSD, ILO and World Bank databases.

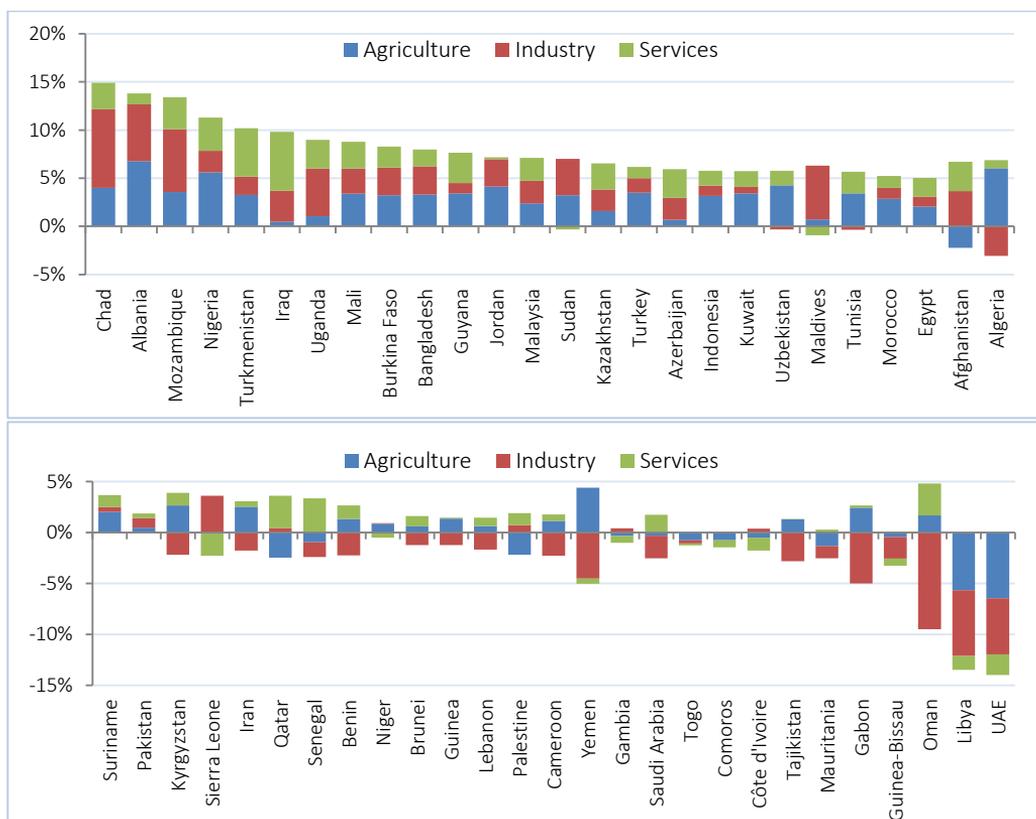
Figure 5: Labour Productivity in Services (1991-2015)
(Thousand USD)



Source: SESRIC staff calculation based on UNSD and ILO databases.



Figure 6: Decomposition of Productivity Growth in OIC Countries (1991-2015)



Source: Author’s calculation based on UNSD and ILO databases. **Note:** Values are calculated by taking the averages of value added and employment for the periods 1991-1995 and 2011-2015 and then calculating the annualized compound growth rates over this period. This is to account for year-specific shocks in value added and employment.

Decomposition of productivity growth at sectoral level during the period 1991-2015 is shown in Figure 6 for individual OIC countries. Except 6 OIC countries out of 53 OIC countries for which data are available, services sector positively contributed to overall productivity growth. While Chad, Albania and Mozambique attained the highest average productivity growth in total, Iraq and Turkmenistan achieved the highest growth rates in services during this period (Table 1).

2.2 The Role of Services in Economic Development and Structural Transformation

Economic growth theories pay no special attention to the role of services, with the exception of some of its sub-components. For example, financial sector development has been viewed as an important factor in effectively allocating financial resources to their most productive uses and thereby promoting growth and development. However, other services activities can also significantly affect economic growth. Health and education services are among the key determinants of the stock and growth of human capital. In the same fashion,



telecommunication and transport services are critical in disseminating and diffusion of knowledge and facilitating the movement of goods and people within and across borders at lower costs. Similarly, business services and retail and wholesale distribution services are important factors in improving business environment and enhancing competitiveness.

The process of structural transformation, in which workers move out of lower productive activities to higher productivity activities, is a critical process in the economic development trajectory. There is evidence that better outcomes of poverty alleviation, productivity and living standards are associated with industrialisation-led processes (Gollin et al., 2016). Although the importance of services for development is also widely recognized, the role of (tradable and nontradable) services in growth and structural transformation is generally less understood. In this context, Balchin et al. (2016) have not found evidence for large differences in labour productivity between services and manufacturing firms in developing countries.

Nonetheless, services remain critical in economic transformation and job creation in developing countries. They constitute a significant share of economic output (GDP), trade and investment, and contribute to productivity growth through their linkages with other sectors. Many services are crucial inputs into the production of other services and goods for export and domestic consumption (World Bank, 2016). The sector can be a critical source of knowledge and technology spillover for the rest of the economy by creating productive employment opportunities with significant occupational mobility across sectors. Moreover, services can change relative prices in the sectors to which they contribute and thereby affect production, investment, trade and employment decisions related to those sectors (UNCTAD, 2017). This creates services-led changes in economic activities by strengthening competitiveness in certain sectors. If these sectors have better prospects for productivity improvements with higher technological intensity, the services-led structural changes can be particularly beneficial for the economy. Such a transformation supports the view that services are an integral part of economic transformation, not an alternative to industrialization.

However, a movement from agricultural activities in rural areas into low productivity service activities in informal sectors in urban areas offers little prospects for economic growth and development. Indeed, many developing countries are facing ‘premature’ deindustrialisation as they become services economies before having a proper industrialisation experience unlike their advanced economies counterparts (Rodrik, 2015). In such cases, medium and high skill requiring manufacturing and services sectors narrowly expand. It is therefore important to invest in economic activities that generate higher productivity. There are many services that are relatively

Table 1: Countries with Highest Productivity Growth in Services during 1991-2015

Iraq	6.12%
Turkmenistan	5.02%
Nigeria	3.45%
Senegal	3.35%
Mozambique	3.30%
Qatar	3.17%
Guyana	3.14%
Oman	3.14%
Afghanistan	3.03%
Uganda	2.99%

Source: Author’s calculation based on UNSD and ILO databases.





skill-intensive and can increase overall productivity. Services with relatively lower skill requirements, such as tourism and transportation, on the other hand, can generate opportunities for employment and better earnings compared to lower productive agricultural activities.

Trade in services is a potential channel for productivity growth (Hoeckman, 2017). Many services provide critical inputs for a large number of industries, and thus contribute to productivity enhancement in these sectors. In this regards, exports and imports of services may be a particularly important channel for productivity growth. Balchin et al. (2016) show that services firms engaged in exporting tend to have higher productivity than their non-exporting counterparts. Therefore, a more open services sector is more productive, with more opportunities for economic transformation. In this regards, policymakers use trade in services policy as well as other policies (such as the provision of supportive infrastructure) to pursue a balanced growth path in which services sectors grow in conjunction with other sectors (Hoekman and te Velde, 2017).

It is also important to improve the performance of services firms that supply exporters because higher-productivity services inputs are more likely to lead to higher-productivity exporters. For instance, engineering and information technology services are knowledge-intensive sectors that are essential to the productivity and sustainability of other economic activities (World Bank, 2016). This reflects the rising 'servicification' of manufacturing, which is defined as the increased use of services in manufacturing in production processes and sales, shows that when the value embodied in goods' exports is considered, services account for 40-60% of global trade (Lanz and Maurer, 2015). In today's global value chains, a significant share of value added in exports of goods is linked with services sector activities. An efficient and productive services sector will also support productivity and competitiveness in exports of goods. Therefore, the role of services cannot be denied in realizing a successful industrialization strategy. Perhaps, many examples of failed industrialization attempts in developing countries are linked to the weak state of services sectors, including financial, health, education, energy, telecommunication and transport services. Conversely, lack of a dynamic and productive manufacturing industry may inhibit the potential role of services sector in supporting structural transformation (UNCTAD, 2016).

In this regards, supportive policies and regulations may be needed for boosting the impact of services performance in supporting economic transformation towards higher value added and productivity sectors. Policy coherence and coordination between services sectors and other areas, including trade, investment, competition and industrial policies are particularly important. In the context of low income countries, access to low-cost, high-quality services can help them to participate in local, regional and global value chains and to achieve socio-economic development objectives. They should also give priority to improving deficient physical and institutional infrastructure as well as financial and agricultural extension services. UNCTAD (2017) also provides a set of policies and regulations for different services sectors. Developed countries specifically consider the role of services in enabling global value chains as the servicification of manufacturing and seek to improve their role in upgrading and moving up the value chain (see, e.g., SNBT 2013).





3 Global Trends in Services Trade

Trade in services is broadly defined to include cross-border exchange through telecommunications channels, the temporary movement of service suppliers or consumers, and establishment in a host country by foreign affiliates that produce/sell services (World Bank, 2016a). In contrast to merchandise trade, services are often intangible, invisible and perishable, and usually require simultaneous production and consumption. This requires in many cases to bring consumer closer to supplier, or vice versa, implying one of them to move so that the transaction can take place.

World Trade Organization (WTO) has defined trade to span four modes of supply:

- **Mode 1 (Cross-border):** Services supplied from the territory of one country into the territory of another. An example is software services provided by a supplier in one country through mail or electronic means to consumers in another country.
- **Mode 2 (Consumption abroad):** Services supplied in the territory of a country to the consumers of another. Examples are where the consumer moves, e.g. to consume tourism or education services in another country.
- **Mode 3 (Commercial presence):** Services supplied through any type of business or professional establishment of one country in the territory of another. An example is an insurance company owned by citizens of one country establishing a branch by means of foreign direct investment (FDI) in another country.
- **Mode 4 (Presence of natural persons):** Services supplied by nationals of a country in the territory of another. An example is a doctor of one country supplying through his physical presence services in another country.

Collecting statistics on each mode of supply is extremely challenging. This makes the analyses and assessments on the relative importance of different modes of supply particularly difficult. There are efforts to collect the services trade statistics from various sources, including balance of payments statistics, by various international organizations. However, there are important shortcomings and limitations of these databases (Lukauskas et al., 2013). Services trade tends to be underestimated because so many services are delivered through a commercial presence in another country. As foreign affiliates and subsidiaries are often considered resident in the country, their production does not count as an export. Moreover, services are often embedded within exports of traded goods, but standard data do not capture this (HSBC, 2015).

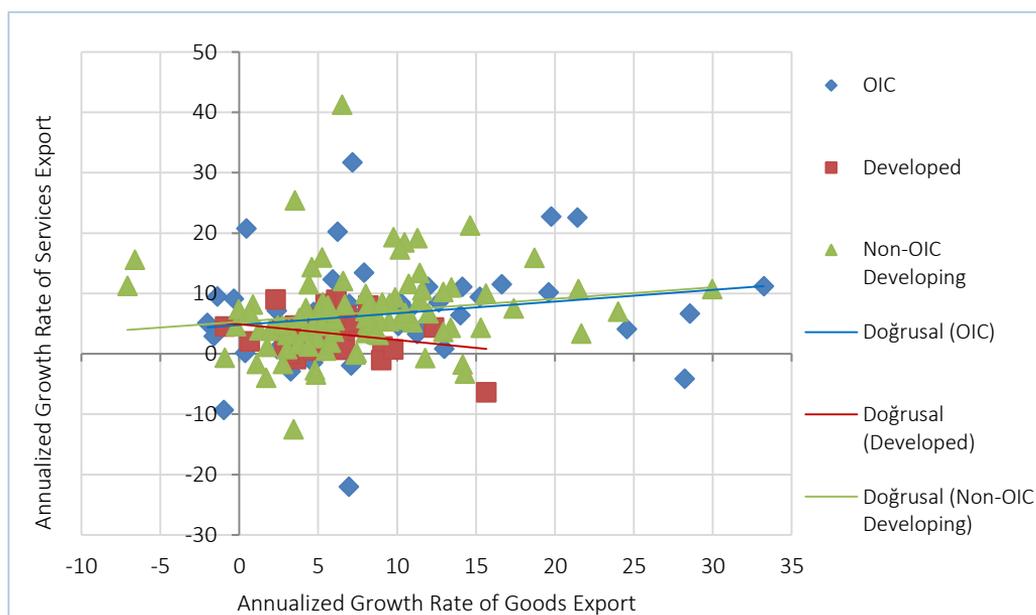




While recognizing these limitations, our analyses in this report are based on the statistics provided by UN COMTRADE and UNCTAD databases. Figure 7 shows the annualized growth rate goods exports and services exports during the period 2005-2015. In OIC countries and non-OIC developing countries, services exports increases as goods exports increases. However, there is a reverse relationship in the case of developed countries. Developed countries tend to export increasingly more services as their exports of goods fall.

Trade of services differ from trade of goods in several important ways. Trade of goods involves shipping goods from one country to another, whereas cross-border trade in services (Mode 1) is only one of the modes by which services are traded. In services trade, two critical aspects are the international movement of factors of production—capital, in the form of FDI, and labour, in the form of temporary labour mobility.

Figure 7: Annualized Growth Rates of Exports, 2005-2015



Source: SESRIC staff calculation based on UNCTAD databases.

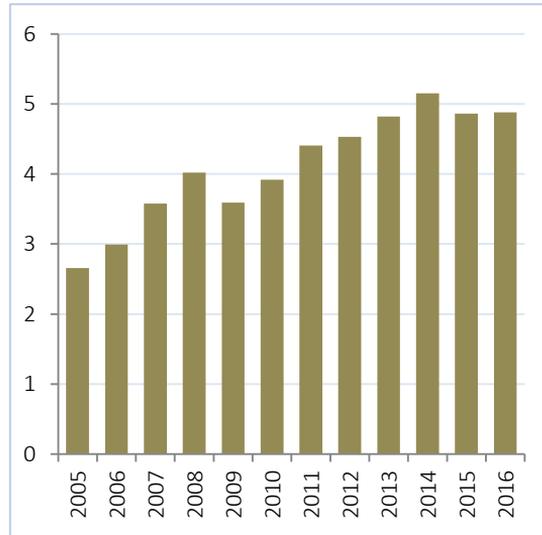
Existing global databases on services trade do not provide detailed statistics on different modes of services trade. Therefore, it is difficult to assess the relative importance of different modes of supply. According to various sources, the most important mode of supply is commercial presence, suggesting that firms serve foreign markets primarily through in-house offshored services activities (Sáez et al., 2014).



Services are playing a growing role in global trade with the increasing tradability of services driven by advancements in technology and regulatory reforms. Specially, improvements in information and communication technologies continue to reduce the needs for proximity between consumer and producer, and allow greater use of outsourcing and offshoring of economic activities. Accordingly, services are becoming more productive, more tradable and more innovation driven.

Figure 8 shows the global trend in services exports during the period 2005-2016. It has continuously increased from USD 2.7 billion in 2005 to USD 5.2 billion in 2014, except the contraction experienced in 2009 due to global financial crisis. Existing data reveal that global services exports decreased to USD 4.9 billion in 2015 and remained at around the same levels in 2016.

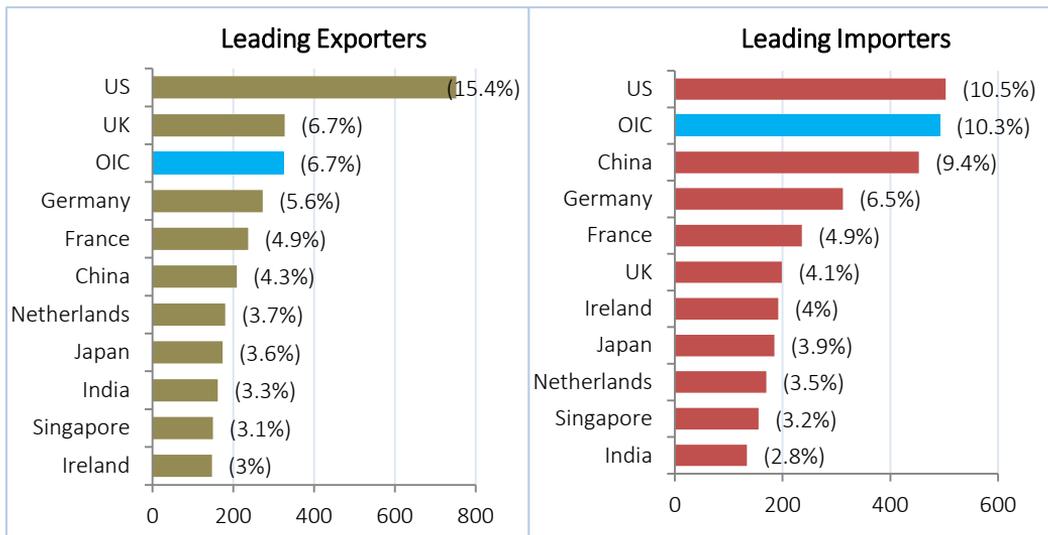
Figure 8: Global Exports of Services, Billion USD (2005-2016)



Source: UNCTAD Database.

In 2016, the largest global exporters and importers of services were mainly developed economies, in particular the United States (USA) and countries in Europe, such as Germany and

Figure 9: Leading Exporters and Importers of Services, Million USD (2016)

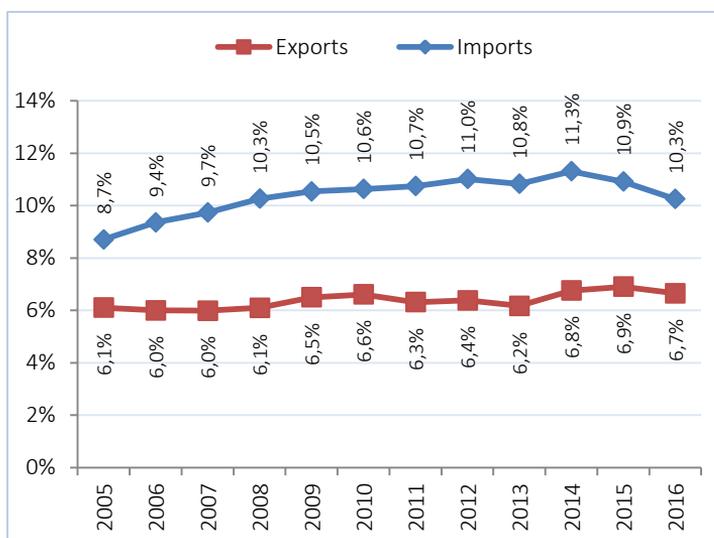


Source: UNCTAD Database. Note: Share in global exports and imports are provided in brackets.



the United Kingdom (UK), as well as emerging economies such as China and India (Figure 9). The top 10 exporters accounted for more than 53% of global services exports, and the same trend was seen among the top 10 importers, where top 10 importers accounted for more than 52% of global services imports. USA was by far the largest exporter of services in the world. Only the UK exported more services than all OIC countries in 2016. Similarly, US alone imported services more than the total import of OIC countries.

Figure 10: Share of OIC in Global Exports and Imports of Services (2005-2016)



Source: UNCTAD Database.

The shares of OIC countries as a group in world total exports and imports of services are reported in Figure 10. Cumulative share of OIC countries has been stagnant at around 6-7% during the period 2005-2016. Being a net importer of services, OIC countries have been accounting around 10-11% of global imports of services since 2008. This reflects the poor performance & inadequate competitiveness of OIC countries in global trade of services.

At sectoral level, different country groups reveal different characteristics of trade. UN Comtrade database provides the data based on Extended Balance of Payments Services classification (EBOPS 2002). This classification includes 11 sectors, which are transportation, travel, communications services, construction services, insurance services, financial services, computer and information services, royalties and license fees, other business services, personal, cultural, and recreational services, and other government services.

Table 2 shows the top sectors where OIC countries, non-OIC developing countries and developed countries export to the world. Travel and transport services are the top sectors in all country groups, but they account for greater share of exports in developing countries compared to developed countries. Transport services exports account around one fifth of all services exports in all country groups. Royalty and license fees (intellectual property) and financial services constitute comparably higher share of services exports in developed countries compared to developing countries.



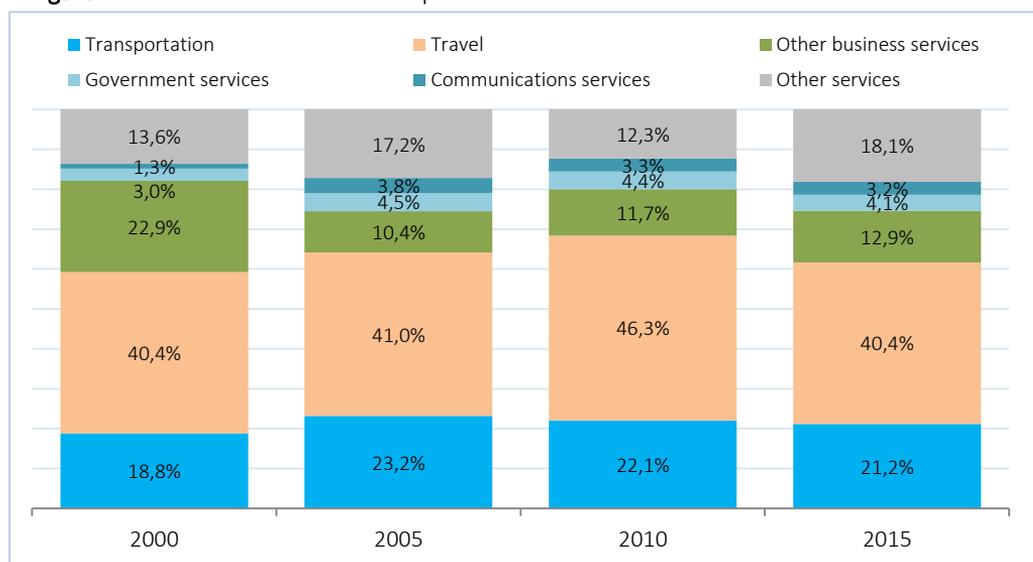
Table 2: Exports of Selected Commercial Services (2015)

Service Category	OIC Countries	Non-OIC Developing Countries	Developed Countries
Travel	40.4%	43.3%	17.7%
Transport	21.2%	20.8%	18.3%
Construction	1.8%	2.1%	1.8%
Financial Services	1.7%	0.8%	4.3%
Intellectual Property	0.1%	1.2%	5.6%
Insurance Services	3.1%	1.7%	1.9%
Other Business	12.9%	19.1%	24.5%

Source: Author’s Calculation based on UN Comtrade Database.

Since 2000, the share of travel services remained consistently above 40% in OIC countries (Figure 11). Together with transport services, top two sectors accounted around 60-65% of all services exports of OIC countries. This reflects the fact that OIC countries are facing challenges in diversifying their services exports and remain dependent on traditionally less sophisticated sectors. This offers limited opportunity to benefit in terms of productivity growth in total economy.

Figure 11: Distribution of Services Exports in OIC Countries



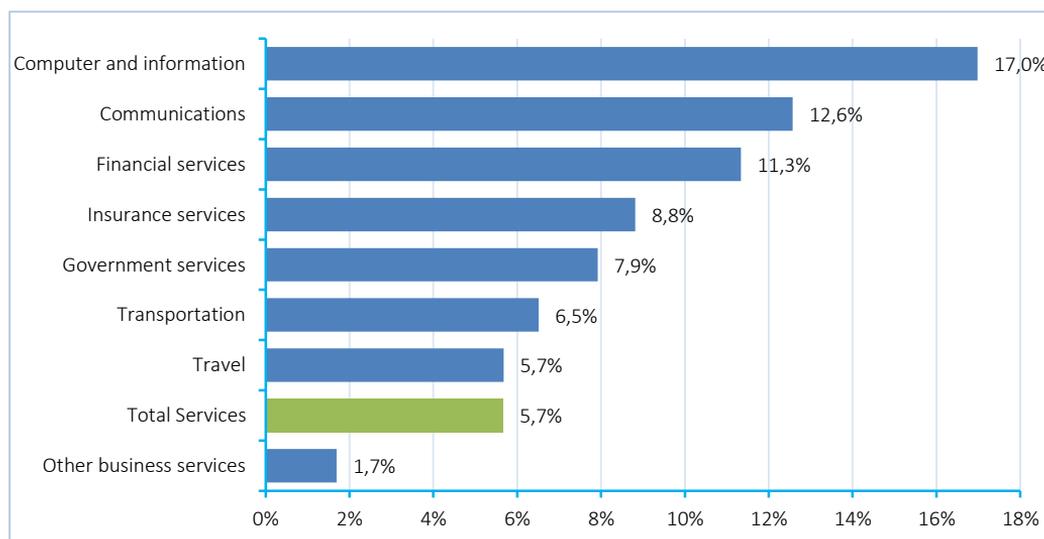
Source: Author’s Calculation based on UN Comtrade Database.

Nevertheless, annual compound growth rates of different services sectors during the period 2000-2015 demonstrates that sectors with greater productivity growth potentials are growing more rapidly than other conventional sectors (Figure 12). Computer and information sector services have grown at an annual rate of 17% since 2000, followed by communications services (12.6%) and financial services (11.3%). Transportation and travel services have grown at an annualized rate of around 6% over the period between 2000 and 2015.





Figure 12: Annual Growth of Services Exports in OIC Countries by Sector



Source: Author's Calculation based on UN Comtrade Database.

At individual country level, United Arab Emirates (UAE) was the largest exporter of services within the OIC group in 2016 (Table 3). With an export value of over USD 63 billion, UAE accounted for 19.5% of total OIC exports of services. The second largest exporter was Turkey with over USD 37.6 billion worth of services and 11.6% share within the OIC region, followed by Malaysia with USD 33.9 billion worth of services and 10.5% share within the OIC region. Top five exporters accounted for 53.9% of total services exports of OIC countries.

Table 3: Leading Exports and Importers in OIC Countries (2016)

<i>Leading Exporters</i>				<i>Leading Importers</i>			
Country	Exports Value	Share in OIC	Share in World	Country	Imports Value	Share in OIC	Share in World
UAE	63417	19.5%	1.3%	UAE	83213	16.9%	1.7%
Turkey	37634	11.6%	0.8%	Saudi Arabia	71159	14.5%	1.5%
Malaysia	33925	10.5%	0.7%	Malaysia	39347	8.0%	0.8%
Indonesia	24151	7.4%	0.5%	Qatar	31541	6.4%	0.7%
Saudi Arabia	15958	4.9%	0.3%	Indonesia	30637	6.2%	0.6%
Morocco	15379	4.7%	0.3%	Kuwait	26239	5.3%	0.5%
Qatar	15176	4.7%	0.3%	Turkey	22215	4.5%	0.5%
Egypt	14305	4.4%	0.3%	Egypt	16978	3.5%	0.4%
Iran	10202	3.1%	0.2%	Iran	14694	3.0%	0.3%
Kazakhstan	6255	1.9%	0.1%	Nigeria	12318	2.5%	0.3%

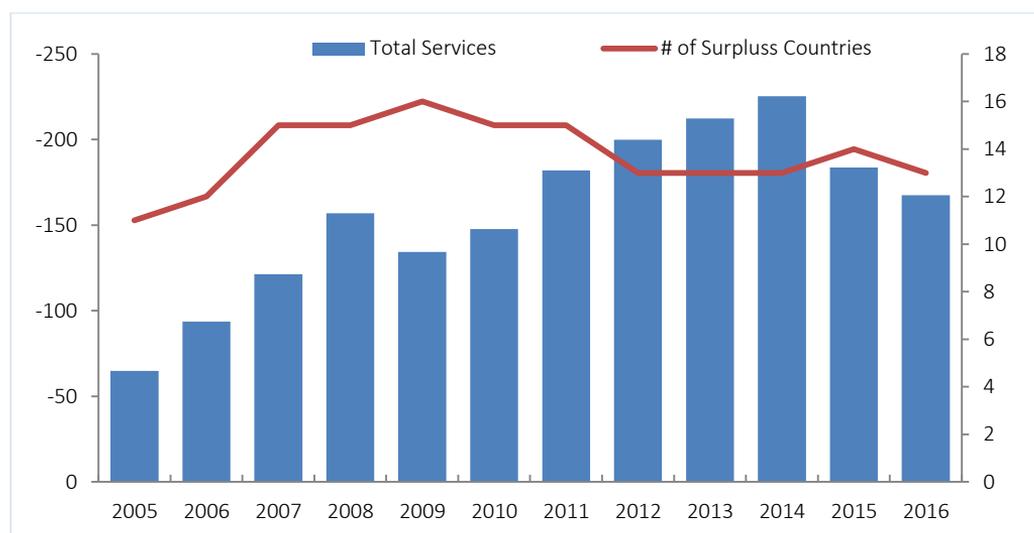
Source: Author's Calculation based on UN Comtrade Database.



Similarly, United Arab Emirates (UAE) was the largest importer of services within the OIC group in 2016 (Table 3). With an import value of over USD 83 billion, UAE accounted for 16.9% of total OIC imports of services. The second largest importer was Saudi Arabia with over USD 71 billion worth of services and 14.5% share within the OIC region, followed by Malaysia with USD 39.3 billion worth of services and 8% share within the OIC region. Top five exporters accounted for 52% of total services exports of OIC countries.

As observed from the Table 3, most of the OIC countries experience a trade deficit in services. In cumulative terms, Figure 13 shows that this deficit is constantly increasing over the years. It has rapidly increased from USD 65 billion in 2005 to USD 157 billion in 2008. After slightly contracting due to global economic crises, trade deficit of OIC countries in services started to increase again after 2009 and reached over USD 225 billion in 2014. Since then, trade balance of OIC countries started to improve again and declined to USD 167 billion in 2016.

Figure 13: Trade Balance in Services (2005-2016)



Source: Author's Calculation based on UNCTAD Database.

During these periods, only a few number of OIC countries could attain a trade surplus in services, which fluctuated between 11 and 16, with an average number of countries of around 13. In 2016, four OIC countries had a deficit over USD 10 billion. Saudi Arabia had the highest deficit with USD 55 billion, followed by Kuwait (USD 21 billion), UAE (USD 20 billion) and Qatar (USD 16 billion). Nigeria, Algeria, Indonesia, Malaysia and Iraq were the countries with over USD 5 billion deficit in 2016. On the other hand, there were only two OIC countries with a trade surplus over USD 5 billion, namely Turkey (USD 15.4 billion) and Morocco (USD 6.7 billion).

When we look at the trade balance statistics at sectoral level, we observe that there were two main sectors where OIC countries had trade surplus: travel and communication sectors.¹ Travel

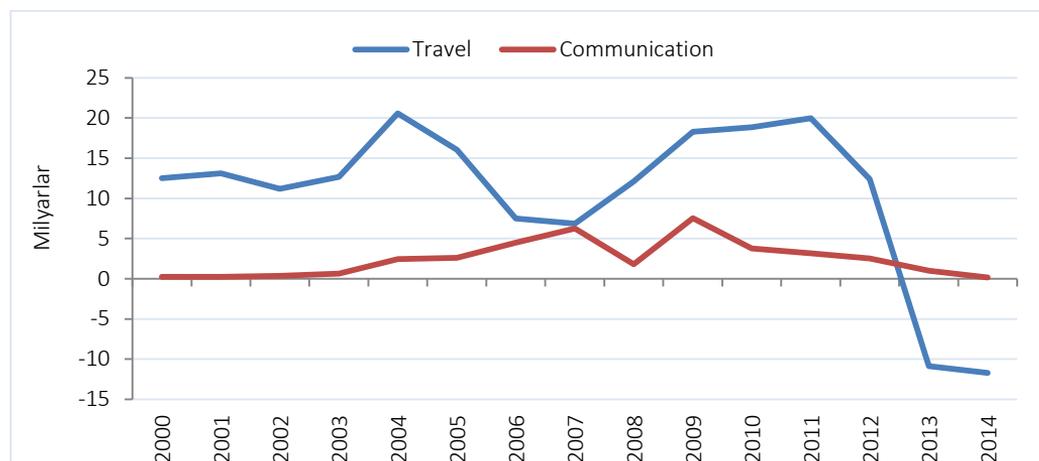
¹ Due to data limitations at sectoral level, analysis could be made only until 2014.





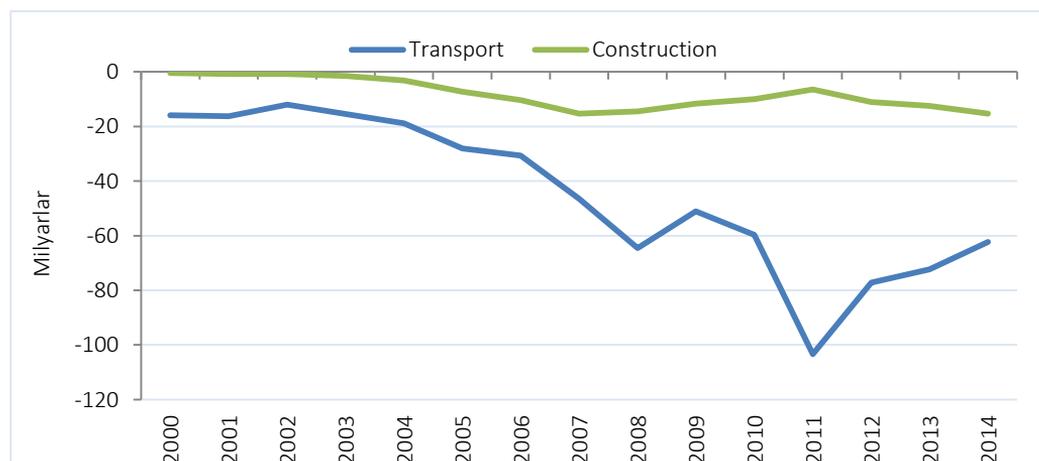
sector has been in surplus until 2013, which sharply turned to deficit (Figure 14). It was around USD 20 billion in surplus, but turned to almost USD 12 billion in 2014. Communication sector was also positively contributing to the overall performance of trade in services, but the surplus reduced to almost below USD 200 million in 2014 compared to USD 7.5 billion in 2009.

Figure 14: Trade Balance at Sectoral Level: Sectors in Surplus



Source: Author's Calculation based on UN Comtrade Database.

Figure 15: Trade Balance at Sectoral Level: Sectors in Deficit



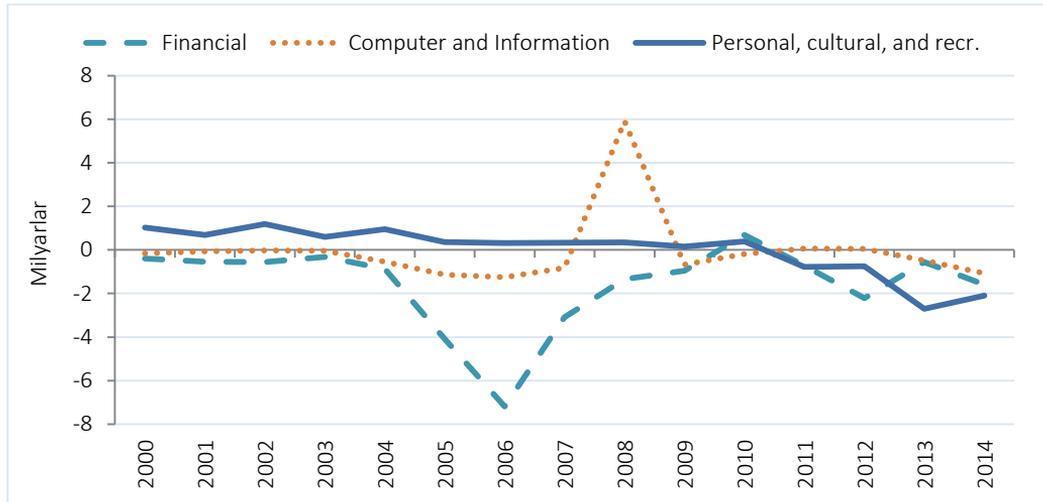
Source: Author's Calculation based on UN Comtrade Database.

On the other hand, the largest trade deficit is observed in transportation sector (Figure 15). It even exceeded USD 100 billion threshold in 2011, but then improved to around USD 62 billion in 2014. Although transport sector is the second largest sector in trade in services of OIC countries, they also attain the largest deficit in this sector. Construction sector is the second largest sector with growth trade deficits, which exceeded USD 15 billion in 2014. Trade balance



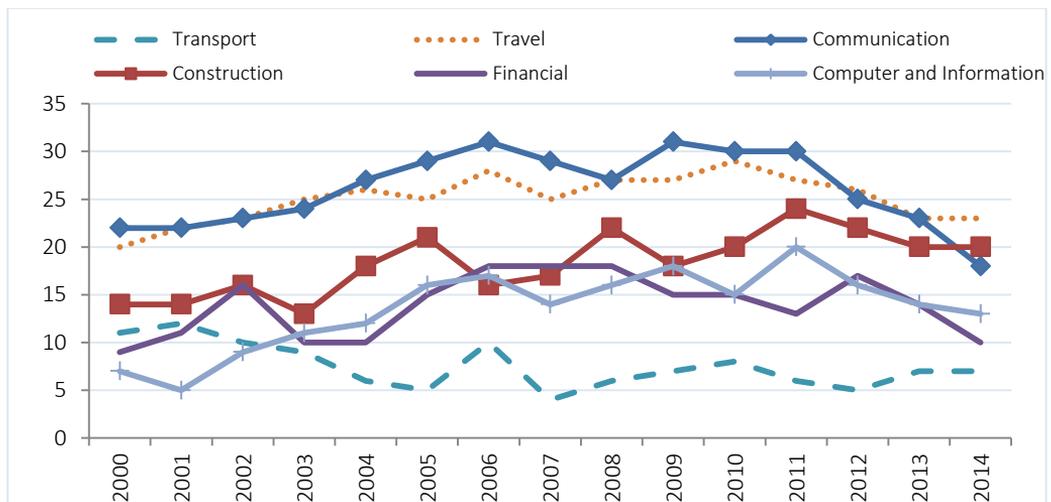
in other sectors, including financial services, computer and information services and personal, cultural and recreational services remained largely in deficit with an amount of around USD 1-2 billion in OIC countries (Figure 16).

Figure 16: Trade Balance at Sectoral Level: Sectors in Deficit



Source: Author's Calculation based on UN Comtrade Database.

Figure 17: Number of Countries with Trade Surplus



Source: Author's Calculation based on UN Comtrade Database.

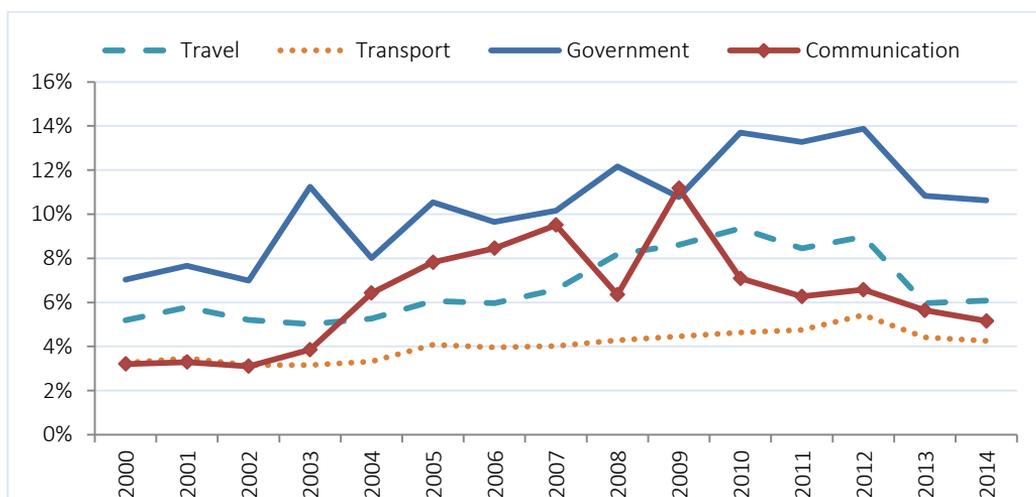
Figure 17 shows the number of OIC countries that have trade surplus in different sectors. The largest number of countries have surplus in communication and travel sectors with around 20-30 OIC countries. In construction sector, the number of countries with trade surplus is increasing over time and remains over 20. Transport sector is where the least number of countries have a surplus, which stood at 7 in 2014.





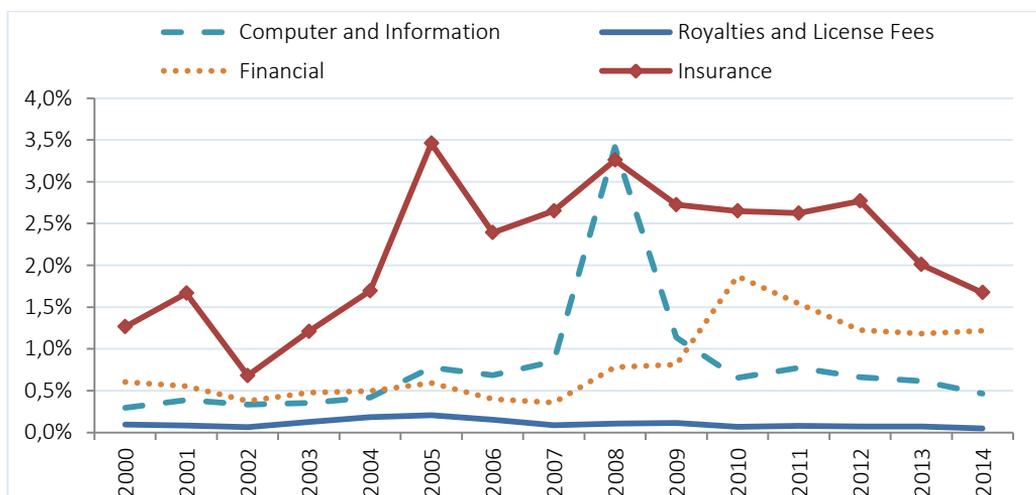
Although OIC countries collectively account for less than 7% of global services exports (see Figure 10), they account over 10% of global services exports in government services (Figure 18). Government services include services related to embassies and consulates; military units and agencies; and other government services. Travel services exports of OIC countries fluctuate between 6%-10% since 2005 and in communication sector it fluctuates between 5%-11% during the same period. OIC countries account for only 4% of global trade in transport services in 2014. Other sectors, which are usually more value-added sectors, represent smaller share of global services exports, typically below 2% (Figure 19).

Figure 18: Share in Global Services Exports by Sectors



Source: Author's Calculation based on UN Comtrade Database.

Figure 19: Share in Global Services Exports by Sectors



Source: Author's Calculation based on UN Comtrade Database.



It is important to find areas for bilateral trade potentials and complementarities in services trade to increase the trade among the OIC countries. However, existing databases on trade in services does not provide enough data on bilateral trade. In UN-Comtrade database, only 3 OIC countries report bilateral trade statistics in services (Azerbaijan, Kyrgyzstan, Pakistan), but not regularly. Turkey, Tunisia and Lebanon also report occasionally. Therefore, an analysis on bilateral trade potentials and complementarities is not possible.

It is also hard to find projections on future trade flows in services. According to the estimations made by HSBC (2015), the value of services exported each year is expected to increase by more than 2.5 times by 2030. Services’ share of global trade will also rise, from 23% in 2015 to 25% by 2030. For the individual OIC countries for which projections are available, the United Arab Emirates, with an average growth rate of 8.3%, is expected to continue to be the top exporter within the group of OIC. Indonesia is expected to experience the highest growth rate with an average annual growth rate of 9.9% (Table 4). In general, OIC countries are expected to witness higher rates of growth compared to other countries for which projections are available. This would help them to reduce their trade deficits and become important exporters in global markets.

Table 4: Forecasted Growth in Services Trade by 2030

	Value of services exports (Billion US\$)		Annual growth rate
	2015	2030	2016–30
USA	751	1,641	5.3%
UK	345	895	6.6%
China	287	818	7.2%
Germany	254	598	5.9%
France	241	567	5.9%
Japan	163	433	6.8%
India	156	523	8.4%
UAE	101	336	8.3%
Korea	98	296	7.7%
Turkey	47	139	7.5%
Malaysia	35	116	8.4%
Mexico	23	63	7.1%
Indonesia	22	91	9.9%
Egypt	19	62	8.3%
Saudi Arabia	16	33	4.8%
Argentina	13	28	5.3%
Bangladesh	3	9	8.5%

Source: HSBC (2015).



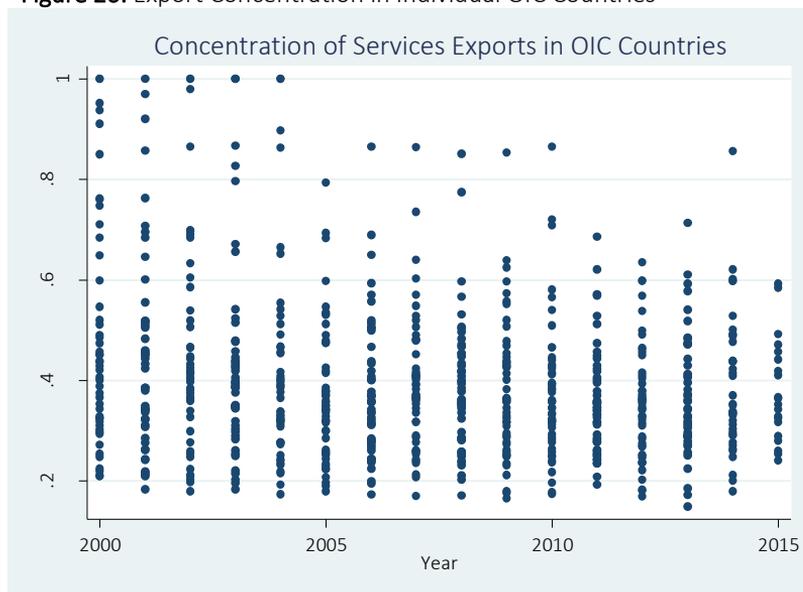


4 Structure of Services Trade in OIC Countries

Analysis on trade in services at sectoral level provides some insights on the structure of trade in OIC countries. However, in order to gain even more insights on the current structure of trade in services, a number of additional analysis will be made. This will include analyses on concentration, quality/productivity and comparative advantages.

Figure 20 shows the level of export concentration in OIC countries during the period 2000-2015, where each dot indicating a specific country. According to Herfindahl-Hirshman Index, where higher values indicate higher concentration or specialization, OIC countries represent rather a concentrated picture of export structure in services. Although there is a slightly increasing trend towards diversification (lower values of the index), overall situation in services exports remain highly concentrated in a few sectors in OIC countries. On average, concentration of exports has fallen between 2000-2008, but increased during 2009-2015, as depicted in Figure 21.

Figure 20: Export Concentration in Individual OIC Countries



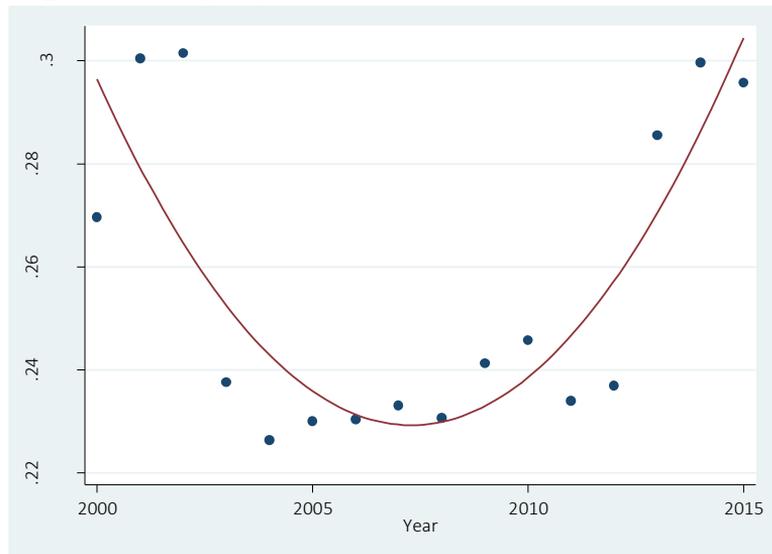
Source: Author's Calculation based on UN Comtrade Database.

Another way of analysing the export structure is measuring export sophistication. In estimating the service export sophistication, we use the methodology developed by Hausmann et al. (2007). In its original framework, the authors use a goods export sophistication



measure – called *EXPY* – as a proxy for the most productive set of goods the country can produce at a given time. They construct the index by using export data, since it is reasonable to expect that countries to export those goods in which it is most productive. Following the same reasoning, we construct the index for services sector.

Figure 21: Average Export Concentration in OIC Countries



Source: Author's Calculation based on UN Comtrade Database.

As in Gable and Mishra (2011), we start by constructing so-called *PRODY*'s for each category of exports, reflecting the income/productivity level associated with each category of services. *PRODY_j* is the income value associated with the service *j*, and is constructed by using the service export (*x*) share of a country *i* in world's export of service *j*, divided by the sum of shares of *j* in world exports of *j* across all countries exporting that service. These ratios are multiplied by the exporting countries' respective per capita income level (*Y*) and the result is summed up across all countries. In other words, the *PRODY* becomes the weighted average of per capita GDPs, where the weights represent the revealed comparative advantage in service *j* for each country. *PRODY*s are constructed for each service category, for each year of available data, and are by construction the same for all countries. *EXPY* is then the weighted income value of services exported by a country, computed as the sum of *PRODY*s using as weights the share of the particular service in the country's total service export basket.² *EXPY*s are constructed for each country and for each year with available data (see Hausmann et al., 2007, and Gable and Mishra, 2011, for more details).

According to the construction of the index, *EXPY* can increase due to (i) an increase in the *PRODY* of a service and/or (ii) an increase in the share of high *PRODY* products in the export basket. Countries with high income and high-skilled labour force can boost the *PRODY*s of services sectors in which they export more. Service export data are not collected in the same detailed manner as goods export data. Therefore, it is not possible to calculate the *PRODY*s at

² More explicitly, *PRODY* and *EXPY* are calculated as follows: $PRODY_j = \sum_i \frac{x_{ij}/x_i}{\sum_i x_{ij}/x_i} Y_i$ and $EXPY_i = \sum_j \frac{x_{ij}}{x_i} PRODY_j$.

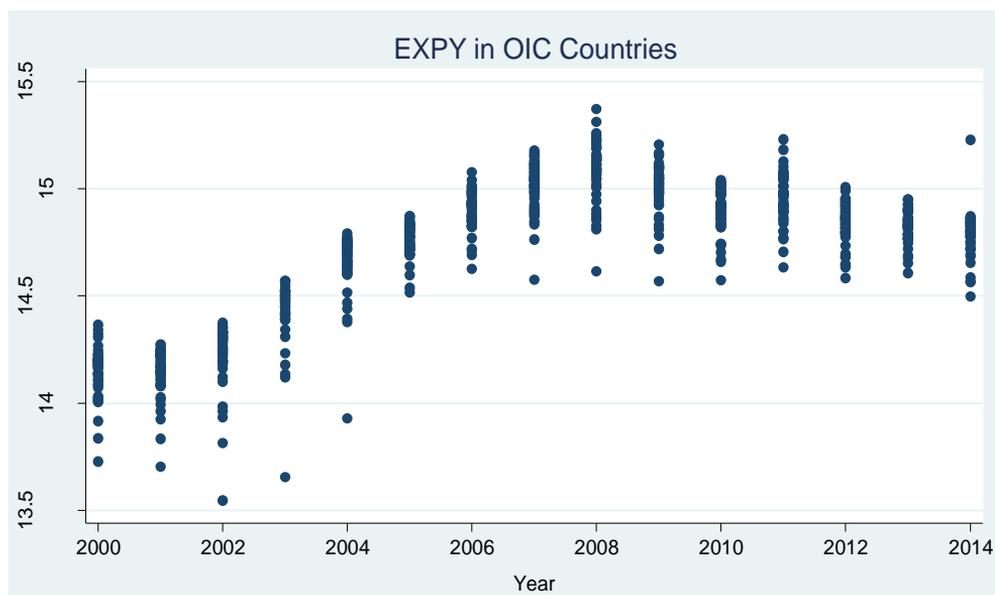




highly disaggregated level. Current statistics allow us to calculate *PRODYs* for ten broad categories of services exports. In calculating export sophistication indexes, we use the export statistics from UN COMTRADE database. GDP per capita data is taken from the World Bank Indicators database.

Figure 22 shows the distribution of EXPY values for OIC countries during the period 2000-2014. Overall, there is an increasing trend in the export sophistication of OIC countries in services sector. Specifically, OIC countries could increase their export sophistication until 2008, but this trend has reversed and they fail to improve their export sophistication any further after 2008.

Figure 22: Export Sophistication in Individual OIC

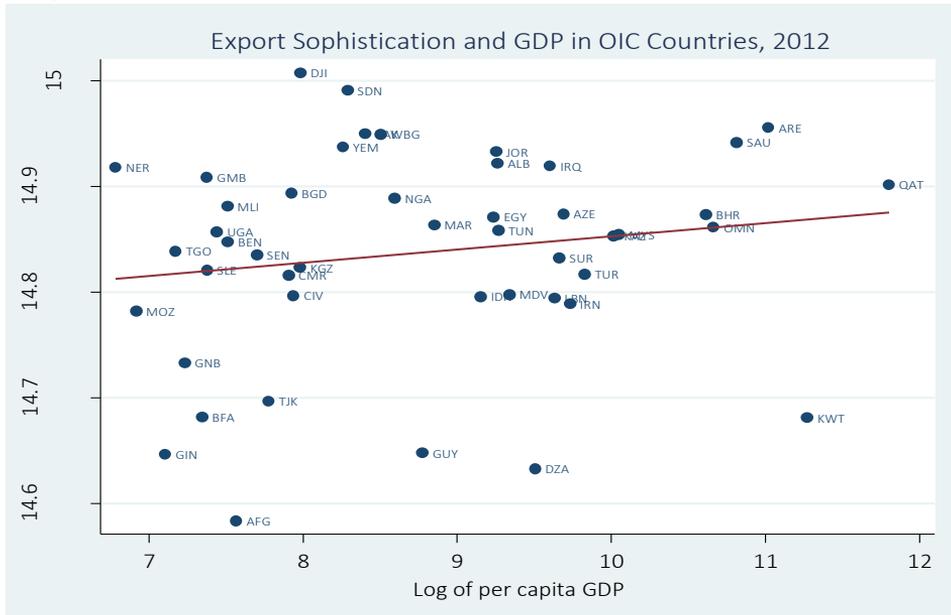


Source: Author's Calculation based on UN Comtrade Database.

There is a positive association between income levels and export sophistication in the case of OIC countries (Figure 23). In non-OIC countries, this relation turns to negative, where high income countries have lower sophistication of exports (Figure 24).

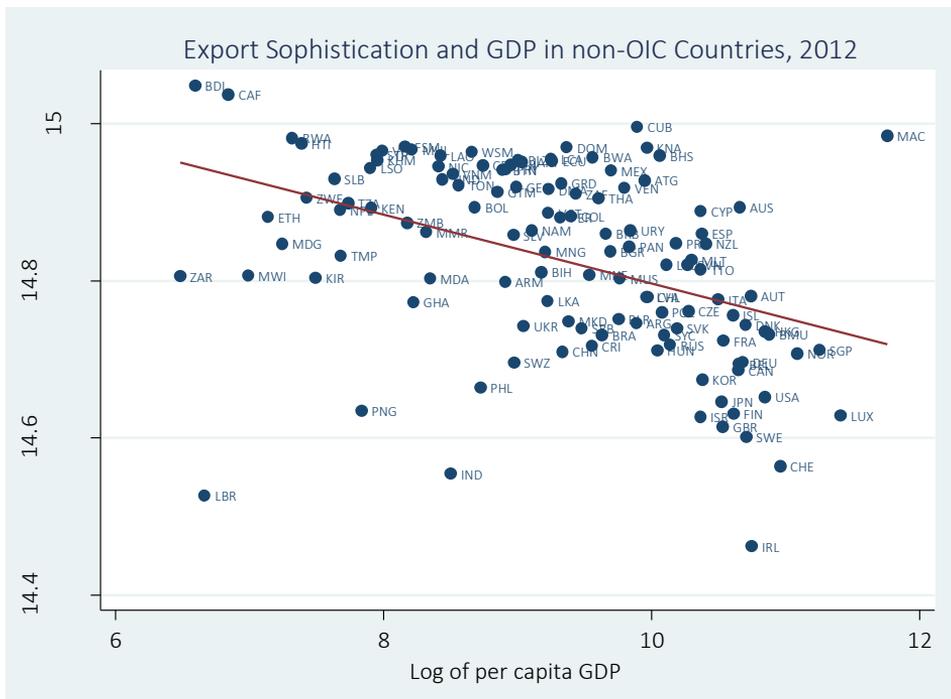


Figure 23: Export Sophistication in Individual OIC Countries, 2012



Source: Author's Calculation based on UN Comtrade Database.

Figure 24: Export Sophistication in Non-OIC Countries, 2012



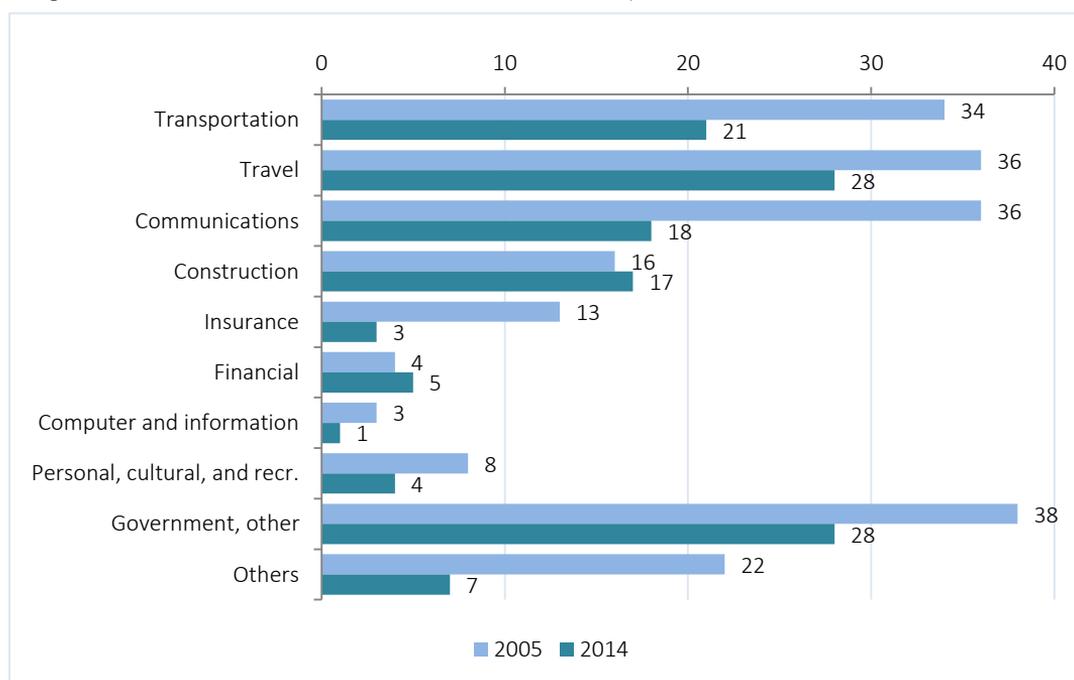
Source: Author's Calculation based on UN Comtrade Database.



Finally, traditional international trade theory suggests that countries should specialize in products or services that they have comparative advantage. Although this theory is highly controversial in terms of supporting economic development, it would be insightful to see in which sectors OIC countries have comparative advantage. For this purpose, revealed comparative advantage (RCA) is calculated for each sector and country to assess a country's export potential in a specific sector. More specifically, it is measured by the product's share in a country's exports in relation to its share in world trade. If the index exceeds unity, the country is said to have a revealed comparative advantage in that product.

Figure 25 shows the number of OIC countries in sectors where they have comparative advantage. In 2005, OIC countries had significant comparative advantage in transport, travel, and

Figure 25: Number of OIC Countries with Revealed Comparative



Source: Author's Calculation based on UN Comtrade Database.

communication and government services. However, they lost their advantage over the years. As of 2014, OIC countries have more advantage in travel and government services. The number of OIC countries with comparative advantage fell sharply in communication and transport services, but increased only in construction and financial services. This reveals that many OIC countries are losing their competitiveness in global services export markets.

In order to investigate the country level comparative advantages, the RCA values for top OIC exporting countries in 2012 are calculated for different sectors. As shown in Table 5, travel, transportation and government services are the sectors where top OIC exporters have



comparative advantages. On the other hand, none of the countries have comparative advantage in computer and information services and royalties and license fees. Interestingly, top three exports, namely UAE, Turkey and Malaysia have comparative advantage only 2 or 3 sectors. Having a comparative advantage is not a must to become a major exporter of services, but at initial phases of developing sectoral competitiveness, countries may need to have and utilize comparative advantages in these sectors.

Table 5: RCA in Top OIC Exporting Countries in 2012

	Turkey	Malaysia	Egypt	Indonesia	Kuwait	UAE	Lebanon	Morocco	Saudi Arabia	Qatar	Iran
Transportation services	0.8	0.7	2.2	1.0	1.2	1.5	0.4	1.0	1.1	2.5	2.2
Travel services	1.2	2.4	1.9	1.6	0.1	2.9	1.9	2.1	2.8	1.2	1.2
Communications serv.	0.2				8.3		1.6	2.0	1.2	1.8	
Construction services	0.8	1.7	1.4	2.0			2.0	0.1			9.8
Insurance services	0.4	0.6	0.2	0.0	0.3		0.5	0.4	1.3	2.4	0.2
Financial services	0.1	0.2	0.1		0.2		1.8	0.1	0.2		
Computer and inf. serv.	0.0		0.8				0.1	0.5			0.2
Royalties and license serv.		0.1		0.0			0.0	0.0			0.0
Other business serv.	0.0	1.0	0.1	1.6	2.3		1.1	0.8	0.0		0.2
Personal, cultural, and recreational serv.	1.8	0.6	0.6	1.2			2.7	0.5		3.8	2.7
Government services	0.5	0.1	1.2	1.7	2.1	3.1	0.5	1.9	2.7	6.7	1.7

Source: Author's Calculation based on UN Comtrade Database.





5 Policies and Agreements in Services Trade

An important policy question is how and what type of government policy can support the development and growth of services activities and increase services sector productivity. Openness to trade is definitely important to ensure access to efficient services and promote economy-wide productivity. Traditional protectionism, including tariffs and quotas, is less appropriate for services activities, because they remain less tradable than goods. It seems more reasonable to facilitate the entry of foreigners to promote the transfer of new technology and systems, which also increases employment of local labour force. Therefore, it is advocated that the focus of services development and trade strategies should be on enhancing the quality of domestic regulation, and improving the skills of the local workforce, infrastructure and business environment so that to encourage more investment in value added services (Saez et al., 2015).

On the other hand, there is a big potential in the export of services from developing countries if market access can be improved in the sectors of their export interest through trade negotiations. Advancements in information and communication technologies provides major opportunities for them to participate in global network of trade in services, which will further promote foreign investment, knowledge transfer and human capital development. While Mode 1 is more liberalized, Mode 4 remains more restricted than other modes of services delivery due to concerns over the potential implications for labour markets. Many countries allow for the entry of highly skilled labour, while limiting entry for lower-skilled labour (UNCTAD, 2014).

Compared with the liberalization of the trade in goods, the liberalization of the trade in services in the WTO has a shorter history. The WTO's General Agreement on Trade in Services (GATS) entered into force in 1995 and it remains the only set of multilateral rules covering international trade in services. The Agreement reflects the increased potential for trade in services brought about by advances in information and communication technology. It identifies four different modes of supplying services, as discussed earlier. At regional level, an increasing number of regional trade agreements (RTAs) include a services component and the regional integration of service economies. As of May 2012, 102 RTAs in force that are notified to the WTO cover the trade in services, compared with only 5 covering the trade in services in 1995 (UNCTAD, 2014). Moreover, within the framework of Trade in Services Agreement (TISA), the EU and 23 WTO members, including Turkey and Pakistan, are negotiating to progress beyond the stalled efforts to update the GATS.

Services covered by the GATS are not automatically opened to competition. WTO members guarantee access to their markets only in those sectors and modes of supply specified in their



“schedules of commitments”, which provide legally binding commitments. The only obligation that applies across all services covered by the GATS is the most-favoured-nation (MFN) principle, meaning suppliers of services from all countries are treated in the same way (Hoekman and te Velde, 2017).

Table 6: The effects of services on economic transformation: illustrative pathways

Sector	Direct effects			Indirect effects (static and dynamic)	Induced/ productivity effects
	Jobs (skilled, medium-skilled or low-skilled workers)	Exports	GDP		
Accommodation and restaurants	Medium important for skilled jobs	Important export revenues	High in certain developing countries	Very important including for less skilled workers	Less important
Education	Important for medium-skilled employment	Less important, apart from a few countries	Relatively high share	Mostly temporary	Important for human capital in the long run
Finance and insurance	Important especially for skilled workers	Potentially a major source of exports and capital inflows	High (around 10% of GDP)	Less important for offshore centres, but potential for forward linkages	Important for finance directed at the real economy
Health	Important for medium-skilled employment	Less important, apart from a few countries	Relatively low share	Mostly temporary	Important for human capital in the long run
Information and communication	Important for a few countries especially for skilled workers	Potentially a major source of exports and capital inflows	Medium (mostly less than 10% of GDP)	Mostly forward linkages	Important productivity effects
Professional and support services	Important especially for skilled workers	Potentially a major source of exports and capital inflows	Low in developing countries	Forward linkages	Important for firm-level productivity
Public administration	Important for low- to medium-skilled workers	Insignificant	Medium to high in developing countries	Medium important	Not very important, except e.g. public infrastructure works
Real estate	Very few jobs	Not important	Important share of GDP	Important effect on construction	Less important
Transport and storage	Potentially important (e.g. truck drivers)	Important for some countries	Important share of GDP	Important	Important for economy-wide productivity
Wholesale and retail	Important for low- to medium-skilled workers	Less important for most developing countries	Important share of GDP	Important effect on agriculture and manufacturing value chains	Less important

Source: Khanna et al. (2016).



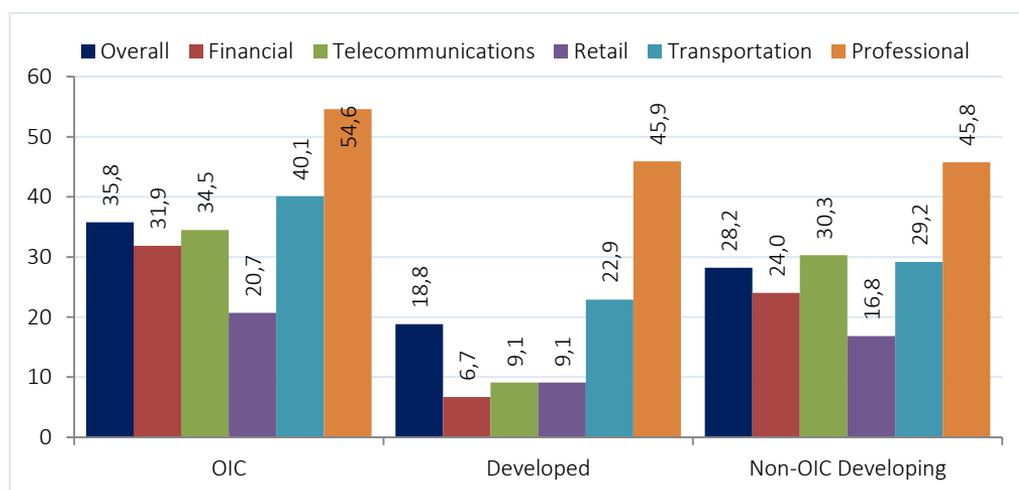


Khanna et al. (2016) introduce a framework that discusses the direct and indirect effects of different sectors on economic transformation. Table 6 shows sectors that are expected to be important for generating employment for different skills levels, increasing trade, output and productivity. Although the table is general and it is very challenging to obtain robust quantitative evidence, it provides valuable information on expected impacts of different sectors in services (Balchin et al., 2016).

Given the importance of the services sector in growth, employment and productivity, it is important to address barriers to international trade in services, which may take the form of prohibitions of foreign providers, limits on foreign ownership and personnel and implicit discriminations in qualification and licensing requirements (UNCTAD, 2017). In order to measure the current level of restrictions in services trade, World Bank developed the Services Trade Restrictiveness Index (STRI) Database, which includes information from 103 countries. The database focuses on five sectors: financial services, telecommunications, retail distribution, transportation, and professional services, with each sector disaggregated into subsectors as applicable. Within each subsector, the database covers the most relevant modes of supply.

Figure 26 shows the simple averages for 29 OIC, 22 developed and 52 non-OIC developing countries in terms of services trade restrictions. On average, OIC countries appear to be more restrictive compared to other country groups.³ Average index value for OIC countries is 35.8, while it is 18.8 in developed countries and 28.2 in non-OIC developing countries. At sectoral level, OIC countries remain the groups with highest protectionism. While retail and financial sector services are least protected, professional services are the most protected activities in all country groups.

Figure 26: Services Trade Restriction Index



Source: Author's Calculation based on World Bank Services Trade Restrictions Database.

³ The database is constructed by using the following classification at different sectors: Completely open (0); Virtually open but with minor restrictions (25); Major restrictions (50); Virtually closed with limited opportunities to enter and operate (75); Completely closed (100).



Restrictions on trade activities in services have of course implications on the development of trade among countries. For example, Hoekman and Shepherd (2015) find that services trade restrictiveness is a statistically significant determinant of manufactured exports performance. A 10% increase in the restrictiveness of services trade policies is associated with a 5% decrease in bilateral trade in manufactured goods. Similarly, Miroudot and Shepherd (2015) find that a 10% increase in the level of STRI is associated with an increase in trade costs of 2.7%. For intermediate trade, a similar change in the STRI is associated with a 3.1% increase.





6 Final Remarks

Services are the fastest growing sector of the global economy, and trade in services has grown faster than in goods over the past decade. They constitute the largest share of global value added, an increasing share of global exports and more than half of global employment. Moreover, services play a key role as inputs into the production of goods and in supporting productivity and competitiveness in other sectors. Services account for major tasks performed and exchanged in global supply chains and in many cases it is difficult to separate manufactures from services.

There is also a transformation within the services sector. While the shares of traditional service exports, including tourism and transport, are falling, exports of modern and more technology intensive services, particularly those related to ICT services, are increasing. This transformation creates direct and indirect employment opportunities, especially for youth. Many countries around the world, including both developed and developing countries, give special importance to the expansion exports of services in their trade and development strategies.

There are, however, major challenges faced by developing countries, including OIC countries, in utilizing the potential of the trade in services in development. Lack of human, regulatory and institutional capacity hinders exporters to export, producers to use imported services inputs and policymakers to effectively regulate and develop services sectors.

In this connection, it is observed that OIC countries fail to diversify their export base and account a good share of global trade in services. Moreover, they are losing their competitive advantages in many services sectors. It would be advisable for OIC countries to focus on sectors where they have comparative advantage and become more competitive in these areas. These sectors are apparently travel, transportation, communication and construction sectors. Developing an efficient and competitive services economy and the trade in services in these and other sectors could significantly contribute to the improvement of the economic outlook for OIC economies.

Trade in services plays also an important role in economic transformation and employment creation, enabling countries to diversify and upgrade their economies through mainly integration into global value chains. Landlocked or geographically disadvantaged countries may focus on sectors where distance and physical conditions are less relevant and that have potential to promote socio-economic development and job creation. This would require building productive capacity and competitiveness in targeted sectors through adequate



national policies and regulations. An inclusive approach and public–private partnerships are necessary to ensure policy and regulatory coherence in policymaking.

Services do not figure prominently in research on economic growth and development. Compared to the vast empirical literature on policies affecting trade in goods, the empirical analysis of services trade policy is still in its infancy. Therefore, there is a need for more empirical analysis at global and regional level to come up with policy oriented recommendations, which in turn requires better statistics. Evidence-based policymaking requires sound, timely and disaggregated data, including even at the firm level.

At international level, as put by UNCTAD (2017), efforts are needed to advance a global services trade agenda in the international trading system that includes preferential treatment, flexibilities, experimentation, adjustment mechanisms and support and capacity-building for developing countries. In order to create an enabling environment for trade in services, there is a need for adequately designing the content, pace and sequence of the liberalization process and coordinating this process coherently with the implementation of national policies and regulations.





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