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Delivering Inclusive Global Value Chains

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Abstract

A large number of Commonwealth and Francophonie (CF) countries experience economic disadvantages in view of the interaction between small domestic markets in conjunction with unfavourable geographical location related to distance from global hubs of commerce, which result in high trade costs. These cost disadvantages must be considered within the context of low value-added shares available at entry-level stages of current GVC participation. Looking forward, two major developments likely to significantly influence future value chain participation include: (1) the emergence of mega-trading blocs; and (2) the rise of developing countries in world trade. In view of these trends, the fragmented nature of global economic governance and emerging production networks require careful deliberation by policymakers. This is so as to better align incentive structures for firms in view of public policy and developmental objectives and hence induce more inclusive future GVC participation.

JEL Classification: F15, F20, F23

Keywords: global value chains, trade costs, developing countries, integration

Contents

Summary

There are inherent structural characteristics which can result in the systemic exclusion of some countries from global value chains (GVCs). A large number of Commonwealth and Francophonie (CF) countries experience economic disadvantages in view of the interaction between small domestic markets in conjunction with unfavourable geographical location related to distance from global hubs of commerce, which result in high trade costs. These cost disadvantages must be considered within the context of low value-added shares available at entry-level stages of current GVC participation.

Longstanding concerns regarding the highly asymmetric distribution of value within GVCs remain unaddressed. Effective value chain governance requires the alignment of incentive structures for firms in view of public policy and developmental objectives. There are risks of advancing a GVC integration agenda without effective global economic governance structures. Sustaining value addition and upgrading processes over time may not be possible unless public and private governance structures are better aligned.

Two major developments are likely to significantly influence future participation in GVCs: (1) the emergence of mega-trading blocs; and (2) the rise of developing countries in world trade. The first dynamic has the potential to make future GVC development more exclusive, while the second may offer new opportunities for more inclusive value chain development. Both aspects require careful deliberation by policy-makers in view of the fragmented nature of global economic governance and need to better align firm incentive structures with development objectives.

1. Introduction

Fundamental changes are taking place in global trade. The traditional predominant notion of an entire production process being undertaken by one firm in one country is being replaced by value chain-led trade. This process involves the cross-border fragmentation of production processes, which entails specialisation in a narrower range of tasks by firms organised within global production networks. Given the limited productive capacity of many developing countries, integrating with global value chains (GVCs) may provide new trade opportunities for local firms to gain access to new markets through specialising in a single task. By becoming part of an international production network, attracting foreign direct investment (FDI) and accessing technological know-how in more dynamic export sectors may be more forthcoming. Given the nature of the tasks involved, GVCs can assist in creating employment-intensive exporting activities, and thus help to achieve the golden nexus of trade, growth and job creation.

Despite the potential of GVCs, however, the growing body of evidence on the nature and impact of GVC participation is mixed. Many poor, small and vulnerable developing countries, including members of the Commonwealth and the Francophonie (CF), have achieved rather more limited GVC participation in more dynamic types of trade to date. In other cases, evidence on the beneficial effects of GVC participation continues to be subject to scrutiny particularly in view of the inability to monitor GVC participation and outcomes by firms and labourers over time because of major data limitations.

There is a proliferation of studies and analyses that consider specific policy measures to promote developing countries' participation in GVCs. While a general consensus on these policy prescriptions appears to exist, in our view the implications arising from certain factors critical for delivering inclusive GVCs have not received adequate attention in the current policy discourse. This discussion note highlights three areas which deserve further consideration by policy-makers in order to more effectively deliver inclusive GVCs: (1) the inherent structural characteristics of groups of countries, which competitively disadvantage participation in certain types of GVCs; (2) the fragmented nature of global governance mechanisms coupled with fragmented production, which can undermine potential developmental gains; and (3) the potential effects of the emerging global trade architecture on future GVC participation.

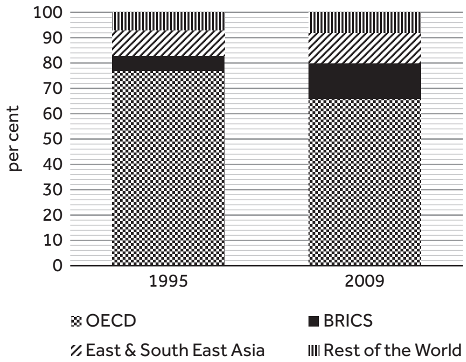
2. Global value chain participation and measures to promote it

Since the early 1990s, the world-export gross domestic product (GDP) ratio has increased from 19 to 31 per cent[1]. This growth in export intensity is partly attributable to the intensification of GVCs. The huge significance of trade in intermediate inputs, now estimated to comprise at least two-thirds of all global trade (OECD 2013), is testimony to this.

However, despite these trends there is strong evidence of highly concentrated GVC participation. It is estimated by the Organisation for Economic Co-operation and Development (OECD)–World Trade Organization (WTO) that almost 92 per cent of trade in value added created by GVCs is due collectively to OECD countries, BRICS (Brazil, Russia, India, China and South Africa) and a few Asian nations (Figure 1). Measures using a different database, United Nations Conference on Trade and Development (UNCTAD)-Eora – as shown in

1 Authors' estimates based on UNCTADstat data.

Figure 1. Value-added trade is highly concentrated

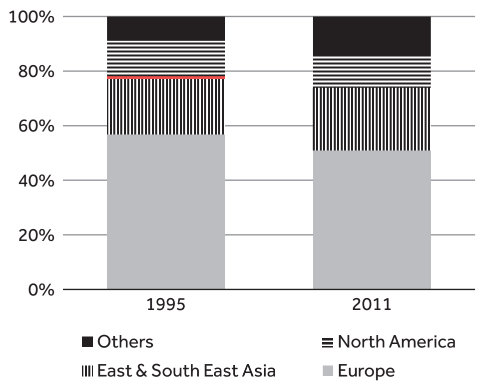


Source: Information as provided in Banga (2013) using OECD-WTO TiVA database

Figure 2 – also suggest that global trade remains concentrated in what has been dubbed as 'Factory Europe', 'Factory North America' and 'Factory Asia' (Baldwin 2011).

Although limited, there is evidence that some least developed countries (LDCs) and African countries are beginning to participate in GVCs as defined by the current mainstream narrative in relation to vertically fragmented trade. 'Transformed exports', including manufactures, semi-manufactures and processed primary products, now feature LDC exports (ITC 2013). Africa's GVCs integration in primary products is found to be increasing (AfDB 2014). However, given Africa's overall overwhelming economic dependence on primary commodity exports, the actual extent and nature of GVC participation is not clear. Currently, very little is known about small states' participation in GVCs, and this may be reflective of limited evidence on services GVCs to date.

Figure 2. Europe, North America and East Asia are three major dominant regions in value-added trade



Source: UNCTAD-EORA GVC database

How countries participate in GVCs and where they are located within the GVC matters. Countries specialising in pre-manufacturing (e.g. research and development (R&D), standardisation, design) and post-manufacturing (logistics, marketing and brand development) activities are able to capture more value in GVCs than countries that specialise in the manufacturing of the products. The value captured by these types of services in GVCs may be considerably more than those attained from manufacturing activities.

It is generally recognised that a large majority of LDCs, small states and sub-Saharan Africa (SSA) countries have failed to add more value by processing their primary exports and moving up the GVCs within which they specialise. Some commodity exporters may become trapped in captive value chains (Nissanke and Mavrotas 2010, Keane 2012). Developing countries may become stuck, exporting low value-added items with lower gains accruing over time (Banga 2013). It has been argued that participating in the lower end of GVCs can be counterproductive, and may lead to a 'hollowing-out' of the manufacturing sector. This disadvantageous process is also known as immiserising growth (Kaplinsky 2005), a phenomenon recognised within the case-study GVC literature of the 1990s but ignored by the current GVC discourse.

2.1 Current policy prescriptions

A number of recent studies discuss options for more effective integration into GVCs. The typical policy considerations include import liberalisation and improved trade facilitation measures to reduce costs of imported inputs, addressing non-tariff barriers, improving the investment climate, investing in infrastructure development and linking GVCs to industrial development policies. These are, of course, important issues for promoting competitiveness and inducing trade responses in developing countries.

However, overcoming all exclusionary barriers to effective GVC participation within the same set of policy prescriptions is simply unrealistic. Moreover, there is a need to more carefully distinguish between interventions designed to (1) assisting small and medium-sized enterprises (SMEs) in entering into GVCs and developing new relationships with lead firms and (2) beginning GVC participation through inviting FDI and production units from abroad.

There are inherent structural characteristics which can result in the systemic exclusion of some countries from GVCs given the competitiveness effects of economic geography. These facts can constrain efficiency seeking FDI flows. Even when countries are integrated with GVCs, they might not be participating in a gainful way in part because of a failure to align value chain governance with developmental objectives, nationally as well as globally. These facts relate to the organisational aspects of production and equity rather than efficiency concerns.

Much of the current GVC literature and its resultant policy implications is reminiscent of the 1990s liberalisation agenda. Although understandings of the complex relationship between trade, growth and the achievement of economic structural transformation have improved in recent years, these lessons do not seem to have been heeded. Finally, the evolving global trade architecture arising from the emergence of mega-regionals and the advent of developing countries as serious players in global trade are likely to be determining factors in future GVC participation. The resultant implications of these issues must be actively considered within the context of promoting inclusive, developmental-oriented GVCs.

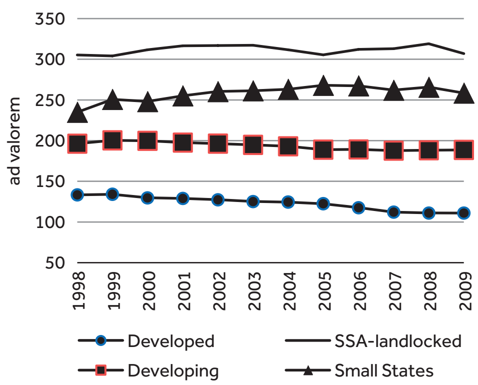
3. Economic geography and value-chains trade

A large number of Commonwealth and Francophonie (CF) countries experience economic disadvantages in view of the interaction between small domestic markets in conjunction with unfavourable geographical location related to distance from global hubs of commerce, which result in high trade costs. These cost disadvantages must be considered within the context of low value-added shares available at entry-level stages of current GVC participation. Firms and production units in these countries are mostly SMEs with limited productive capacity and technological capabilities.

3.1 Evidence of trade cost disadvantages

Analysis of data from a pioneering World Bank–United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) project confirms the severe competitive cost disadvantages faced by many landlocked SSA countries and small states (Figure 3). Measured in *ad valorem* equivalent terms, the average trade costs for the group of small states and landlocked SSA identified is much higher than for other country groups[2]. While developed countries have experienced considerable declines in trade costs and developing countries show a generally declining trend, this is not the case for small states (Figure 4).

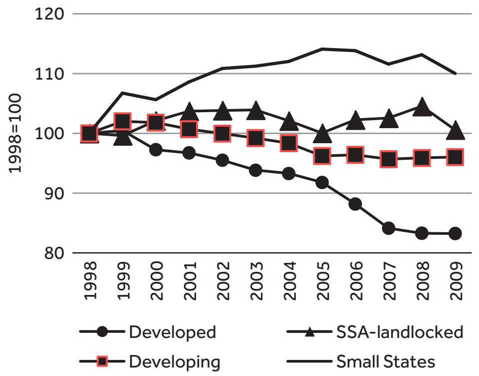
Figure 3. Trade costs are much higher for small states and landlocked SSA



Source: Authors' computation using World Bank-UNESCAP data. Calculations are based on bilateral costs with 10 largest global importers.

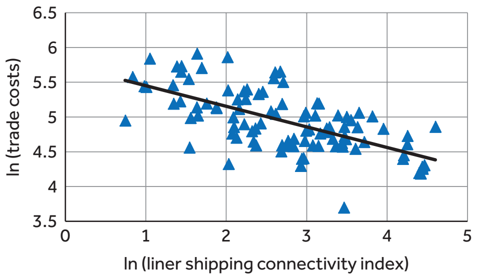
2 This paper uses the Commonwealth Secretariat definition of small states. These are defined as independent states with populations of up to 1.5 million with a few exceptions. This definition follows the World Bank small states classification with some exclusions of countries that are classified as 'developed' by UNCTAD. This sample includes 49 countries, 31 of which are Commonwealth members.

Figure 4. Unlike others, trade costs for small states and landlocked SSA have not been declining



Source and note: Authors' calculation. Advalorem equivalent trade costs are converted into index number with 1998=100.

Figure 5. Trade costs are negatively related to improved shipping connectivity

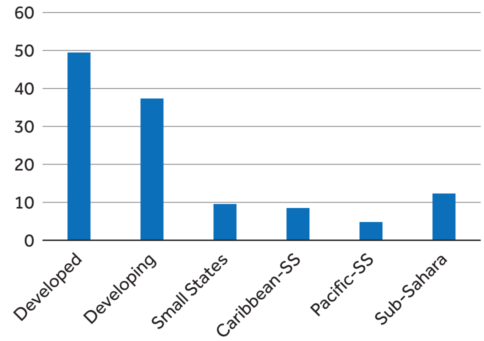


Source: Authors' illustration with liner shpping index data from UNCTAD and trade costs data from World Bank-UNESCAP.

While geographical distance between bilateral trading partners exerts the largest impact on trade costs, other factors such as liner shipping connectivity are also shown to have an important influence (Arvis *et al.* 2013). Indeed, the liner shipping connectivity index (a high value indicates better connectivity) and trade costs are strongly and inversely correlated (Figure 5). Even with improvements in shipping connectivity, unfavourable geographical location coupled with small consignments may indicate limited trade gains (Figure 6).

These excessive costs have serious implications for trade in general and participation in GVCs in particular. A 10 percentage point increase in transport costs is found to reduce trade volumes by about 20 per cent (Limao and Venables 2001). Moreover, country *ad valorem* transport costs of 20 per cent on both final output and intermediate goods reduces domestic value added (including wages and profits) by 60 per cent when intermediate goods account for 50 per cent of costs. The implication is that because of geographical location foreign firms might be reluctant to move or relocate their production to these countries even when the wages are low (Redding and Venables 2001).

Figure 6. Small states and SSA have much lower liner shipping connectivity index



Hence, the typical policy prescription of liberalising trade, ensuring good domestic policies and automatically attracting FDI and inducing GVC participation is likely to be a misnomer within these circumstances. It has been argued that distance matters more in supply chains, and even with today's information and communications technology (ICT) revolution, global production networks are likely to remain concentrated in low-wage nations that are near, or even contiguous with, high-technology nations (Baldwin 2011). This reality poses a major challenge to the current GVC narrative. The fragmentation process of the future will be different from that in the past and is likely to be at a much lower level of disaggregation and a finer level at the task. This is something to which policymakers must be better sensitised. Others point out that the fragmentation process of services has hardly taken place yet[3]. These future developments are likely to be of particular interest to many Commonwealth small states.

3 Lanz and Maurer (2015) also point out that advances in statistics by enterprise characteristics and by mode of supply, i.e. taking into account the movement of labour and capital, are required in order to better understand trends.

4. Value creation and distribution: effective governance of global value chains

Longstanding concerns of CF developing members regarding the highly asymmetric distribution of value within GVCs remain unaddressed. Effective value chain governance requires the alignment of incentive structures for firms in view of public policy and developmental objectives. There are risks of advancing a GVC integration agenda without effective global economic governance structures.

As GVCs have been fragmented across countries, they have also become more tightly coordinated by lead firms; this process is reflected in movement from more arm's-length relations towards closer inter- and intra-firm relations[4]. New estimates by UNCTAD (2013) suggest that 80 per cent of global trade occurs within networks coordinated by multinational enterprises (MNEs) and around 30 per cent of this is in the form of intra-firm trade.

Developing countries may have begun to trade more, but they may not necessarily be gaining more from this trade (UNCTAD 2002, 2013). This is because lower value-added activities have been disbursed by lead firms, whilst higher value-added activities have been retained. Manufacturing stages of production have simply become less valuable over time for producers locked into this stage of production[5]. We summarise some of the relevant findings from the more case-study-based GVC literature below:

- **Coffee**: It is estimated that the farm gate price of coffee, which is subsequently divided up amongst traders, producers and labourers, equates to around 10 per cent of the final retail price of coffee sold on supermarket shelves. This is compared with the 22 per cent which accrues directly to retailers or 51 per cent if prepared own-brand coffee is marketed by the retailers (Fitter and Kaplinsky 2001).[6] Because of the collapse of the International Coffee Agreement in 1989, the liberalisation of coffee marketing systems and entrance of new actors trading more virtually, local producers and traders in coffee-exporting countries are bearing the full brunt of low and increasingly unstable coffee prices[7]. Considering a major coffee-exporting SSA country, Uganda, where 90 per cent of the population are involved in subsistence farming with around 1.5 million households associated with coffee-related activities, there is evidence to suggest that Uganda trades within a captive value chain[8].
- **Garments**: In terms of the distribution of value added within the apparels sector, 70 per cent of the retail price is retained by lead firms in the United States while manufacturing activities, including sourcing of raw materials from third countries and the involved shipping costs, account for the remaining 30 per cent[9]. In the process, factory workers in an LDC such as Bangladesh, are estimated to receive just 1 per cent of the total value of the finished product. The sector is a major employer of women.
- **Horticulture**: In terms of value distribution for the average firm, it is estimated by Hortiwise (2012) that Kenyan growers receive 15 per cent (US$0.11) of the total retail value compared with the 64 per cent (US$0.74) retained by retailers. This is around the same level as reported by Dolan and Humphrey (2000) for the horticulture sector, as well as

4 For example, UNCTAD (2013) draws attention to equity and non-equity modes of international production.

5 Kraemer et al. (2011) found that for every US$299 iPod sold in the USA the value captured from these products through assembly in China was around $10, i.e. 3.3 per cent of the total value of the final product.

6 See also Gibbon and Ponte (2005) and Oxfam (2005).

7 According to Newman (2009) international coffee markets have become financialised with firms dealing in physical commodities as well as other financial services, and hence more resemble financial holding companies.

8 Keane (2012, 2014) argues that the coffee GVCs in Uganda now resemble more of a captive value chain given the low supplier competence in the face of increasingly complex transactions and a transactional dependence on lead firms.

9 Report by Moongate Associates, available at: http://tppapparelcoalition.org/uploads/021313_Moongate_Assoc_Global_Value_Chain_Report.pdf (accessed 20 March 2015).

for the deciduous canned fruit sector (Kaplan and Kaplinsky 1998). As with the garment sector in Asia, the horticulture sector in Africa is a major employer of women.[10]

Many CF developing countries are trapped in low value-added segments of GVCs and highly asymmetric power relations between chain actors are not conducive in terms of advancing desired social and developmental objectives. Buyers and lead firms are becoming more demanding but they do not always provide support or transfer knowledge and capabilities[11] or offer higher price margins to incentivise economic and social upgrading. Even leaving aside the issue of distribution, such low shares of value added now available within the entry-level stages of GVCs further emphasise the formidable challenges faced by CF members with amplified trade costs due to economic geography considerations.

Based on the available evidence from GVC case-study analysis, it is becoming clear that increasing and sustaining value addition and upgrading processes over time may not be possible unless public and private governance structures and public/private actor incentive structures are aligned. This obviously becomes much more challenging within the context of globalised firms operating without effective global governance structures.

Simply reducing trade costs at the border (e.g. in the way of improved trade facilitation) is unlikely to alter the existing highly unequal distribution of value added. Cutting trade costs across the board could actually result in increased competition amongst developing countries in a race to bottom and engagement with the low-value-added components of supply chains. It has been suggested that actively promoting GVCs is a strategic choice for policy-makers (OECD–WTO–UNCTAD 2013). However, to date, consideration of the viability of existing global governance in managing value chains has not been given due consideration. Given the very real forces of convergence and divergence in operation within the global economy, there are concerns that the ascendency of GVCs might actually accentuate these processes[12].

5. The new emerging trade architecture

5.1 Mega-regional trade agreements: rewriting the rules

For capacity-constrained CF members, a strengthened multilateral trading system with transparent and enforceable rules is most essential to protect and promote their trade interest. There are concerns that these rules will be compromised and become less relevant within a new patchwork of mega-regional trading blocs, emanating from the three main GVC hubs: the USA, Europe and Asia.

These super trading blocs have the potential for trade diversion effects, which could harm excluded countries. Being important sources of FDI, these regional arrangements can cause investment diversions (Kher 2015). Furthermore, rules and provisions negotiated and agreed under these new regional frameworks are likely to be more elaborate and encompassing. Without adequate support capacity-constrained excluded countries excluded countries may find it difficult to comply (Palit 2014), which may further compromise the scope of their participation in GVCs unless appropriately designed future GVC development becomes more exclusive than inclusive.

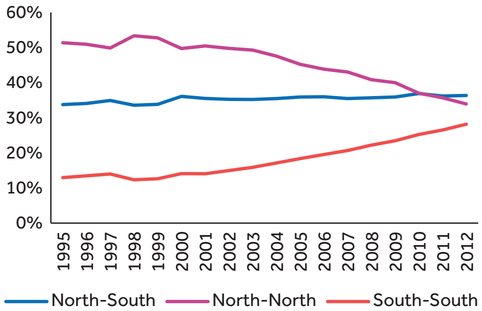
These new developments come at a time of already radically transformed trading relations between the European Union (EU) and ACP (African, Caribbean and Pacific Group of States). Any further market access undertaken by the EU towards third-parties is likely to increase already intense competitiveness pressure on ACP suppliers. Because it is not yet known which new mega-regional trade agreement will

10 As argued by Kasente (2012) there is a need for gender equality issues to be integrated into all stages of coffee production and marketing if women are to realise prosperity from their labour and to move up the value chain as active participants and decision makers.

11 See Pietrobelli (2008).

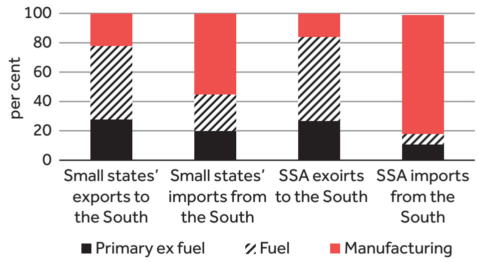
12 See Keane and Basnett (2015) forthcoming.

Figure 7. The relative significance of South–South trade rising rapidly



Source: Razzaque and Gosset (2014)

Figure 8. Small states and SSA mainly export commodities to and imports manufactured good from the South



Source: Razzaque and Gosset (2014) based on data from UNCTADstat

be implemented first, the issue now is one of sequencing and adaptation for the ACP.

5.2 The rise of developing countries in global trade: new demand drivers

The rising significance of developing countries within global trade is another factor that is likely to exert a strong future influence on GVC development. Almost half of global merchandise exports and about 40 per cent of world GDP is now attributable to developing countries. An important feature of this development is the rapidly expanding trade between developing countries: the average annual growth of South–South trade since 2000 has been 17 per cent, compared with the world trade growth rate of 10 per cent. This has caused the relative significance of the trade between developed countries (i.e. North–North trade) to decline from about 53 per cent in the late 1990s to just 34 per cent in 2012 (Figure 7).

Trade with fast growing developing countries offers new opportunities for specialisation, efficiency gains, investment and export market diversification. Some of the BRICS members, particularly China and India, now provide improved market access to LDCs. They have also become important sources of technical and financial assistance. Nevertheless, there are concerns that increased South–South trade has bypassed a large number of SSA and small states. The nature of trade patterns with emerging economies indicates that SSA and small states predominantly export primary commodities and import largely manufactured items (Figure 8). Although there is apprehension about the nature of specialisation within South-South trade, the growing significance of developing countries within global trading flows offers new opportunities for forming regional supply chains. It is widely recognised that most production networks and supply chains are regional in nature. For example, studies have identified the potential for developing regional supply chains in SSA and South Asia in such sectors as textiles and clothing, leather and leather products and agro-processing[13]. As much as 40 per cent of intra-SSA trade takes place in manufacturing, indicating significant scope for developing regional production networks.

Another important aspect of the rise of developing countries is owing to empirical evidence that suggests that new markets and growth centres are closely related to growth in neighbouring countries (see, for example, Redding and Venables 2004, Moore 2015). The growth of such countries as Nigeria and South Africa is thus likely to have a positive impact on neighbouring countries in SSA (Moore 2015). Hence, delivering inclusive regional value chains may be a more achievable objective than the pursuit of GVCs, in some cases. For small economies and firms, regional value chains linking neighbouring countries may offer more sustainable growth opportunities and manageable scales than global markets (Gereffi and Luo 2014).

13 See Commonwealth Secretariat and UNCTAD (2011).

6. Charting the way forward and concluding remarks

Advancing an inclusive GVC agenda, as the discussion in this paper has made clear, faces a number of formidable challenges. In this sense, there is a need for a more nuanced approach and greater consideration of the unique development challenges faced by CF states. Ensuring more inclusive GVC participation requires greater consideration of the heterogeneity of capacity-constrained CF states. The development of a more appropriate global trade support architecture must be considered within the context of a rapidly changing global trade landscape.

6.1 Adapting to the new global trade landscape

The implications of the new global trade landscape characterised by mega-regionals and the rise of the global South are the two most dominant trends with important implications for future GVC participation. The following points should be taken into account:

- Any new agreement reached by the major drivers of the mega-regionals should be accompanied by a commensurate development package to mitigate any adverse consequences for capacity-constrained developing countries.
- In the light of on-going developments, there is a real need to enhance the trade policy review process and trade surveillance mechanisms of the WTO to ensure that potential damaging trade effects are identified and quantified and adequate flanking and sensitisation measures are undertaken to support excluded countries.
- This may entail developing new mechanisms to disburse Aid for Trade for new forms of trade-related adjustment.

The rise of the global South offers opportunities for developing regional supply chains, as a result of the emergence of new growth poles and hubs of commercial activities. While the current pattern of international specialisation in which SSA and small states largely supply primary commodities to emerging Southern partners is of concern, there is some evidence of the potential of developing regional supply chains involving manufacturing and agro-processing sectors. Delivering inclusive regional value chains may be a more achievable objective than the pursuit of GVCs, in some cases, and deserves more attention[14].

6.2 Delivering more targeted Aid for Trade

The Aid for Trade support initiative has assisted many developing countries with their enhanced regional integration and improved trade facilitation efforts. However, the existing support mechanism needs to duly recognise the special and unique development challenges faced by small states. While there is evidence of Aid for Trade being effective in promoting trade facilitation, its effect on productive capacity (i.e. in generating export response from tradeable sectors) is not clear[15]. Given their distinct characteristics, support measures that are required to address similar challenges elsewhere may not be suitable for them. For example, improving regional connectivity by building cross-border road and rail networks invariably has limited relevance for small island states. The following points should be noted:

- A narrow focus on trade facilitation measures, although necessary, will not be sufficient to induce more inclusive GVC development. A strong case can be made for small state-specific support measures in addition to innovative changes to existing mechanisms.
- The potential for services trade-led value chain development needs to be explored for countries with excessive trading costs.

14 See Navas-Alemán (2011), Kamau (2009), Brandt and Thun (2010), UNCTAD (2013).

15 For example, see Commonwealth Secretariat-supported analytical studies on Aid for Trade, as in Razzaque and Te Velde (2013).

6.3 Effectively governing global value chains

The governance of GVCs, including the relationships between lead firms and local suppliers, is an area that needs to be better understood in order to secure more inclusive GVC development. This requires more active consideration as to how to induce movement into higher value added activities as well as the enhancement of domestic value added and spillover effects from existing participation. The current pattern of highly unequal distribution of value-added along GVCs, coupled with declining value added for particular functions, is not conducive to the design of more inclusive approaches.

- There are concerns regarding the development of local firms' technological capabilities and the achievement of social and economic upgrading processes over time, and the empirical evidence is mixed and highly context specific.
- All governments are grappling with the balance between state and business interests and the appropriate alignment of incentive structures.
- Unless Aid for Trade is better targeted at increasing bargaining power within GVCs, there are concerns that potential benefits may flow to those with power within the chain, not to the intended beneficiaries[16].
- In the absence of effective global governance mechanisms, there are concerns regarding the creation of competitive incentive schemes which can undermine, rather than promote, social upgrading processes.

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