



# Trade Hot Topics

## Participation of Small Economies in Global Value Chains: Evidence and Policy Issues

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### Background

Small economies face both challenges and opportunities when trying to integrate into global value chains (GVCs). By specialising in specific tasks or stages within a value chain, small economies can, to a certain extent, mitigate their lack of economies of scale. Furthermore, small economies can use GVCs to help with export diversification, employment creation and technology as well as knowledge transfers.

Such integration, however, comes with its own set of challenges: small size and remoteness are two natural challenges that small economies have to address; others, include difficulties related to accessing finance, inadequate transport infrastructure, complying with safety and health standards, upgrading labour skills, ensuring sound legal institutions and improving the national business environment.

This issue of *Commonwealth Trade Hot Topics* focuses on the integration of small economies in value chains in the agrifood, seafood, and textiles and apparel sectors in the case of goods, and in tourism as well as IT and business process outsourcing in the case of services. The paper also highlights small

economies' trade policy options related to foreign direct investment (FDI), small and medium-sized enterprises (SMEs), regional integration, transport infrastructure, logistics and trade facilitation.

This article is based on a more detailed analysis undertaken in WTO (2015) and covers selected 32 small economies (Table 1). The distinguishing characteristics of these countries are that many have a small market size, narrow resource base and small or restrictive economies of scale; many too are islands and are situated in remote locations. Moreover, many of these countries are also highly vulnerable to natural disasters.

### Small economies are less integrated in goods value chains

Integration into GVCs is often analysed using data on trade in intermediate goods. In 2013 non-fuel, intermediate goods constituted 34 per cent and 40 per cent of small economies' exports and imports, respectively. Such trade is relatively more important at the world level, where it accounted for 46 per cent of total trade in 2013. This lower share of intermediate exports and imports reflects the relatively lower integration of small economies into GVCs and their product and sector specialisation.

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**Table 1: Small Economies Included in the Analysis**

ISO3	Country name	ISO3	Country name	ISO3	Country name
<b>Africa</b>		<b>Caribbean</b>		<b>Central and South America</b>	
CPV	Cabo Verde	ATG	Antigua and Barbuda	BLZ	Belize
MUS	Mauritius	BRB	Barbados	ECU	Ecuador
SYC	Seychelles	CUB	Cuba	SLV	El Salvador
<b>Asia/Pacific</b>		DMA	Dominica	GTM	Guatemala
BRN	Brunei Darussalam	DOM	Dominican Republic	GUY	Guyana
FJI	Fiji	GRD	Grenada	HND	Honduras
MDV	Maldives	JAM	Jamaica	NIC	Nicaragua
PNG	Papua New Guinea	KNA	St Kitts and Nevis	PAN	Panama
WSM	Samoa	LCA	Saint Lucia	PRY	Paraguay
LKA	Sri Lanka	VCT	St Vincent and the Grenadines	SUR	Suriname
TON	Tonga	TTO	Trinidad and Tobago		
VUT	Vanuatu				

This section provides evidence of the integration of small economies in selected goods value chains. Table 2 already indicates that the selected value chains are of significant importance for small economies in terms of export receipts and also in terms of comparative advantage.

#### **Agrifood**

Agrifood products are among the main export products of small economies and are part of a value chain which has experienced significant changes over the last decades due mainly to population

growth, urbanisation, changing diets, information and communication technology (ICT), and structural transformation in retail markets.

Modern agrifood value chains are buyer-driven chains where large retailers or food manufacturers constitute the lead firms. Suppliers in agrifood are required to comply with a myriad of public and private food standards which are particularly important in the case of upgrading into packaging and processing.

Figure 1 illustrates the positioning of small economies in agrifood GVCs through exports of

**Table 2: Exports of Small Economies (SEs) in Selected GVC Goods Sectors in 2013**

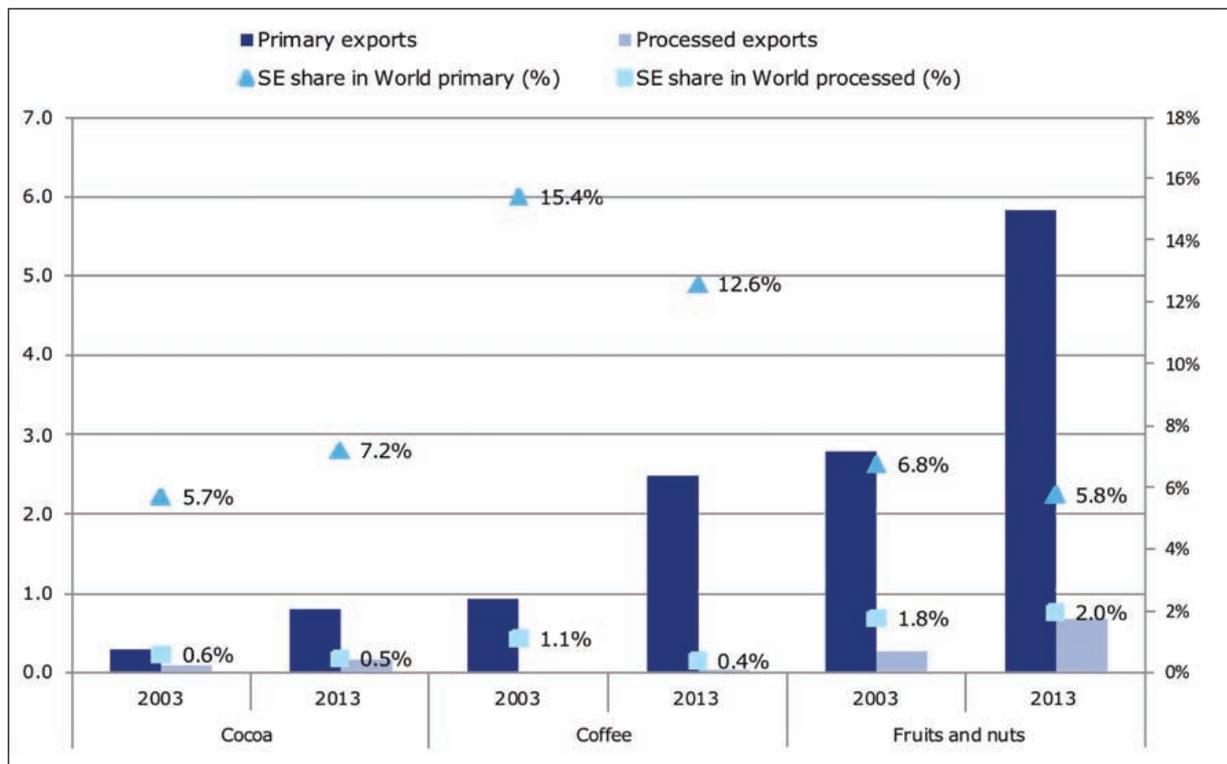
	US\$ (mill.)	Share in SE's goods exports (%)	RCA	Share of processed products (%)*
Cocoa	972	0.7	2.7	16.8
Coffee	2,524	1.8	11.5	1.4
Fruits and nuts	6,508	4.7	6.3	10.2
Crustaceans and molluscs	2,820	2.1	8.4	2.7
Fish	4,699	3.4	7.1	90.5
Textiles and clothing	16,976	12.3	3.0	8.6

Source: CEPII BACI database

Note: Revealed Comparative Advantage (RCA) is calculated as the ratio of the share of a product in small economies' merchandise exports divided by the share of the product in world merchandise exports. An RCA measure larger than one indicates a revealed comparative advantage in a particular product.

\*Based on the UN Broad Economic Categories (BEC) classification. In the case of textiles and clothing products, the BEC classification is used to distinguish between intermediate and final products.

**Figure 1: Selected Agrifood Exports of Small Economies by Processing Stage (US\$ billion)**



Source: CEPII BACI database

Note: The BEC classification is used to distinguish between primary (BEC 111, 112, 21) and processed (BEC 121, 122, 22) agrifood products. The products are defined following the HS 2002 product classification: Cocoa – HS chapter 18; Coffee – HS chapter 09; Fruits and nuts – HS chapter 08 and HS headings 2006, 2007, 2008 and 2009.

primary and processed products of cocoa, coffee, and fruits and nuts. Among the three product groups, exports of fruits and nuts are highest in value reaching almost US\$5.8 billion for primary products and US\$0.7 billion for processed products in 2013. It is shown that small economies are positioned at the initial stages of the agrifood value chain. For all three product groups, small economies display a substantially higher share in world exports of primary products compared to processed products. For instance, in 2013, small economies accounted for 12.6 per cent of world exports of primary coffee but only for 0.4 per cent of processed coffee. Furthermore, comparing 2003 and 2013 reveals that in terms of processed exports, small economies could only gain market share in fruits and nuts.

Exports of fruits and nuts are the most important among the three product groups, accounting for almost 5 per cent of small economies' exports compared to 1.8 per cent and 0.7 per cent in the case of coffee and cocoa, respectively. Coffee and fruits and nuts are of particular importance for countries in Central and Latin America where they account for 3.1 per cent and 7.6 per cent of exports, respectively. The gap in export competitiveness in primary versus processed

agrifood products points to untapped export potential in the latter and to upgrading challenges in agrifood value chains.

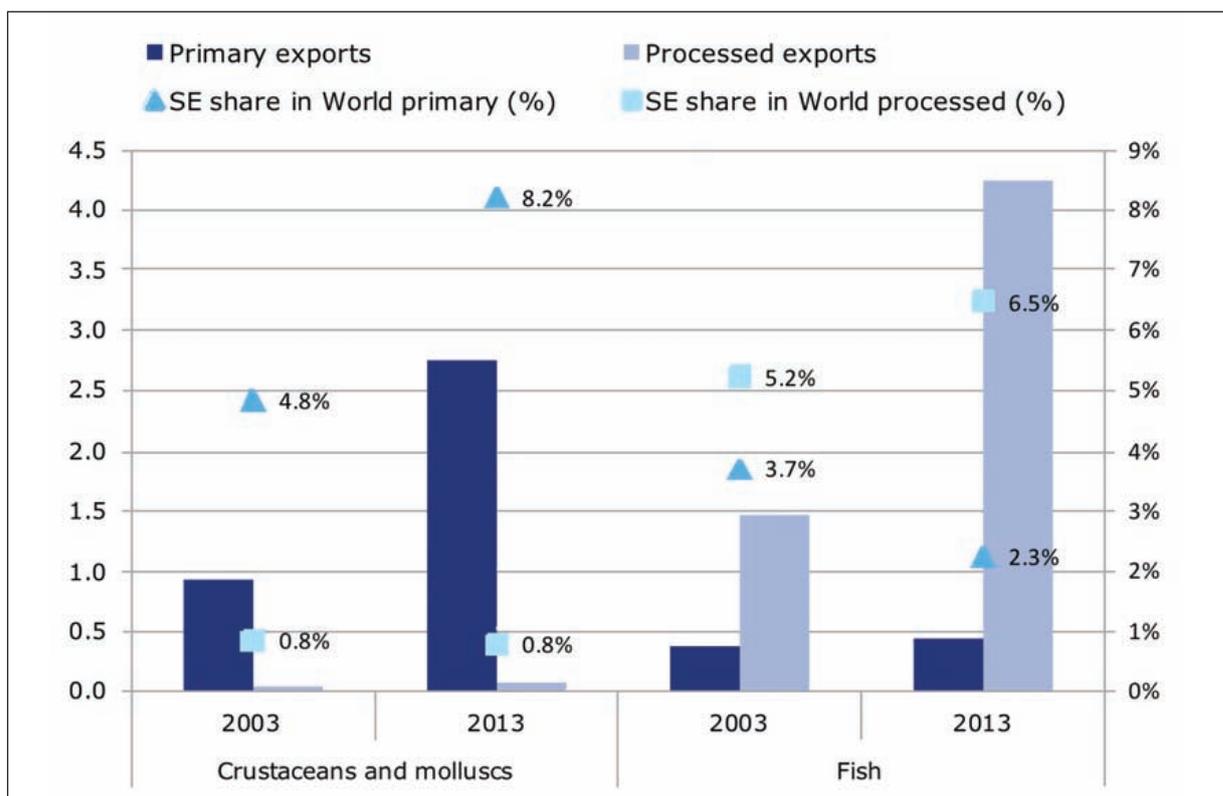
### Seafood

Seafood value chains have also experienced profound changes in the last decades. Technology improvements such as GPS, satellite monitoring or genetically modified organisms have increased the productivity of wild fishing and boosted aquaculture production. But standards compliance remains a challenge.

The small-scale fishery sector accounts for 90 per cent of fishery employment and is particularly relevant in developing countries. According to a FAO study (Bjorndal et al., 2014) on value chain dynamics in small-scale fisheries, small-scale fishers and fish farmers receive relatively less value compared to processors and retailers. One way to support the viability of small-scale fishery in small economies is through the creation of linkages with the tourism value chain.

Figure 2 shows that while small economies exported below US\$0.5 billion of primary fish products in both 2003 and 2013, their exports of processed fish almost tripled from below US\$1.5

Figure 2: Crustaceans and Fish Exports of Small Economies by Processing Stage (US\$ billion)



Source: CEPII BACI database

billion in 2003 to US\$4.2 billion in 2013. This increase also reflects an increasing positioning of small economies at processing stages in fish value chains, as their share in world trade of processed fish increased from 5.2 per cent in 2003 to 6.5 per cent in 2013.

In contrast to fish exports, most of small economies' exports of crustaceans and molluscs are in primary form. Small economies have almost tripled their primary exports from US\$0.9 billion in 2003 to US\$2.7 billion in 2013, so that their world market share increased from 4.8 per cent to 8.2 per cent. In contrast, processed crustacean and mollusc exports accounted for only 0.8 per cent of respective world exports in both 2003 and 2013, even though exports doubled from close to US\$0.04 billion to just below US\$0.08 billion.

### Textiles and apparel

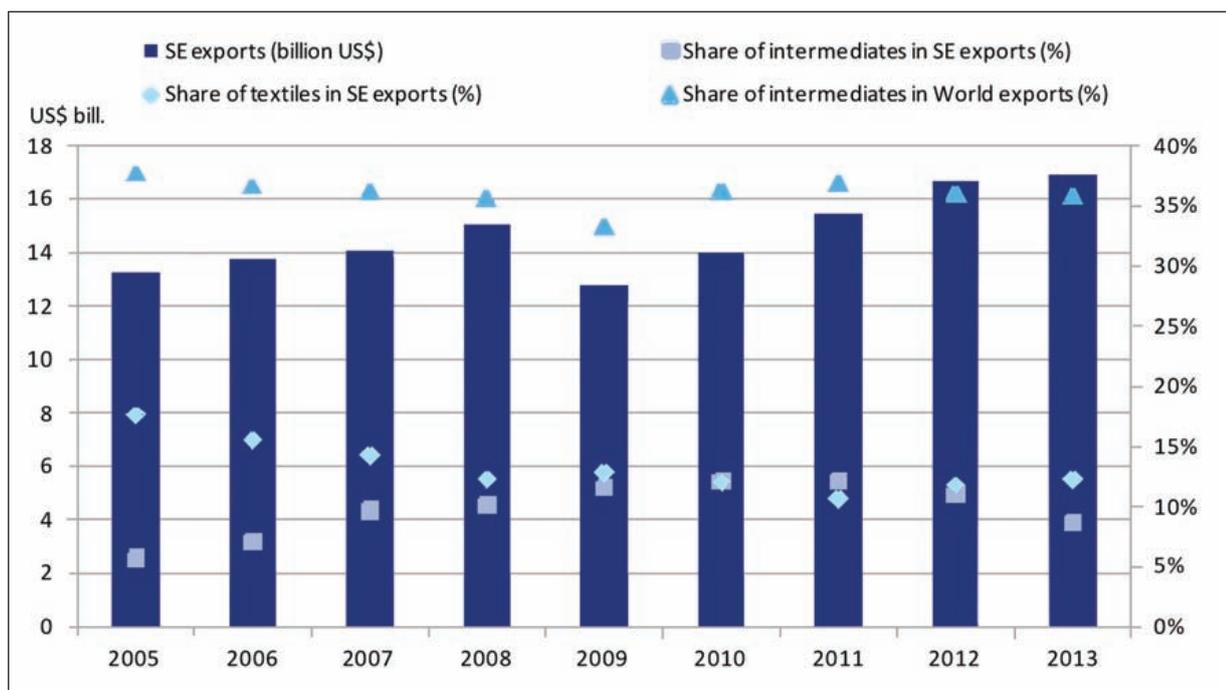
Textile and apparel value chains are of major importance for several small economies, particularly in Central America and the Caribbean, but also in the Asia/Pacific region. Small economies differ in their position in the chain. One example is Sri Lanka which has strong linkages to global buyers. Its firms have been able to upgrade by adding design to their functional portfolio and by producing more complex niche products such as

women's underwear, intimate apparel and sportswear (Fernandez-Stark et al., 2011a).

Figure 3 provides an indication of the importance of textiles for small economies' exports and of the latter's positioning in the textile and apparel value chain. Exports of textiles amounted to almost US\$17 billion in 2013, corresponding to 12 per cent of total small economies' exports. The export share of textiles decreased in the years 2005 to 2007. This was likely due to the phasing out of quotas under the WTO Agreement on Textiles and Clothing (ATC). Exports have remained relatively constant since then.

The share of intermediates in exports of small economies has fluctuated around 10 per cent in recent years as compared to a share at the world level of 35 per cent. Hence, in comparison to the rest of the world, small economies tend to be specialised in the assembly stages of apparel production while other countries tend to produce more intermediate textiles such as yarn and fabrics. Europe and North America constitute the main markets for exports of final products. While small economies in Africa and in the Asia/Pacific region export more apparel to Europe than to North America, small economies in the Caribbean and South and Central America almost exclusively deliver to the North American market.

Figure 3: Textiles Exports of Small Economies and Share of Intermediates



Source: CEPII BACI database

## Services value chains

### Tourism

Tourism is a sector of major importance for many small economies. In 2013, tourism accounted, on average, for almost 9 per cent of GDP across 30 small economies, which is three times as much as the world (3%). At the regional level, the average share of tourism in GDP was 16 per cent in the three small economies in Africa, 14 per cent in Asian/Pacific small economies, 8 per cent in the Caribbean and only 4 per cent in Central and South America. Tourism accounts for almost half of small economies' services exports, which also reflects their comparative advantage in the sector (see Table 3).

The tourism value chain consists of various international and national activities. In particular, core components of the tourism value chain include travel organisation and booking, transportation, accommodation, food and beverage provision, handicrafts, excursions as well as cultural and natural assets (UNWTO, 2013). International linkages in the value chain are mostly related to travel organisation and booking as well as international transportation. However, most of the activities in the tourism value chain take place in the destination country.

Tourism has many backward linkages to other sectors in the domestic economy such as agriculture (e.g. food supply to hotels),

construction, communications, utilities (e.g. supply of electricity and water to hotels) and conference and events management. Hence, through the creation of backward linkages to other sectors, tourism can contribute to the economic diversification of small economies and the growth of sectors such as agriculture, fishing and services. However, this requires sound policy planning and co-ordination among different ministries.

Tourism can be a driver for development. It played an important role in the graduation from LDC (least developed country) status of Cabo Verde and Maldives in 2007 and 2011, respectively (Honeck, 2012). Between 2005 and 2011, Cabo Verde and Maldives experienced annual growth of travel exports of 20 per cent and 37 per cent and both economies are highly dependent on tourism, with travel exports accounting for 93 per cent of Maldives' services exports and 66 per cent of Cabo Verde's services exports.

### IT and business process outsourcing

Advances in information and communication technology have opened up opportunities for small economies to use IT and business process outsourcing (BPO) to diversify their exports. Entry points can include services in areas such as call centres, data entry and processing centres, and back offices (such as purchases, logistics, accounting, claims and payment processing). Determinants of competitiveness in IT and BPO

**Table 3: Exports of Small Economies in Selected GVC Services Sectors in 2011**

	US\$ (mill.)	Share in SE's services exports (%)	RCA	Growth p.a. 2005-11 (%)
Travel	22,950	48.2	1.95	6.7
Computer and information	539	1.7	0.29	19.8
Other business	2,457	7.3	0.28	7.8

Source: WTO Secretariat

services include a skilled labour force in terms of language, IT- and business-related skills and access to high-quality, competitively-priced ICT networks.

Only few small economies have been relatively successful in developing an IT and BPO sector. Computer and information services account for only 1.7 per cent of small economies' exports while other business services account for 7.3 per cent (Table 3). Among the 32 small economies, Sri Lanka, Mauritius and Jamaica are the three biggest exporters of computer and information services.

Jamaica has a locational advantage as a 'nearshore' investment location to North America, operating in the same time zone and sharing English as a main language. In particular, thanks to government support, Jamaica experienced large foreign direct investment inflows into its telecommunications infrastructure, including the development of the IT-focused Montego Bay Free Zone (UNCTAD, 2013). Similarly, Central American countries such as the Dominican Republic, El Salvador and Guatemala are trying to position themselves as 'nearshore' platforms for offshore services to the Hispanic market in the USA (Fernandez-Stark et al., 2011b).

Sri Lanka has made good progress in following India's path to position itself as an offshore destination for IT and BPO services. There are over 300 IT and BPO companies that operate in Sri Lanka, mostly small and medium companies and a few large global players. Sri Lanka has developed an export-oriented software industry focusing on telecommunications, banking, financial services and insurance (BFSI) and software testing, and is the only small economy that has a revealed comparative advantage in computer and information services exports.

### Policy issues

The increasing fragmentation of production has opened up new opportunities for small economies at the level of production stages, services and

sectors. Policy-makers in small economies have a number of trade policies at hand that can facilitate the integration of their firms into value chains.

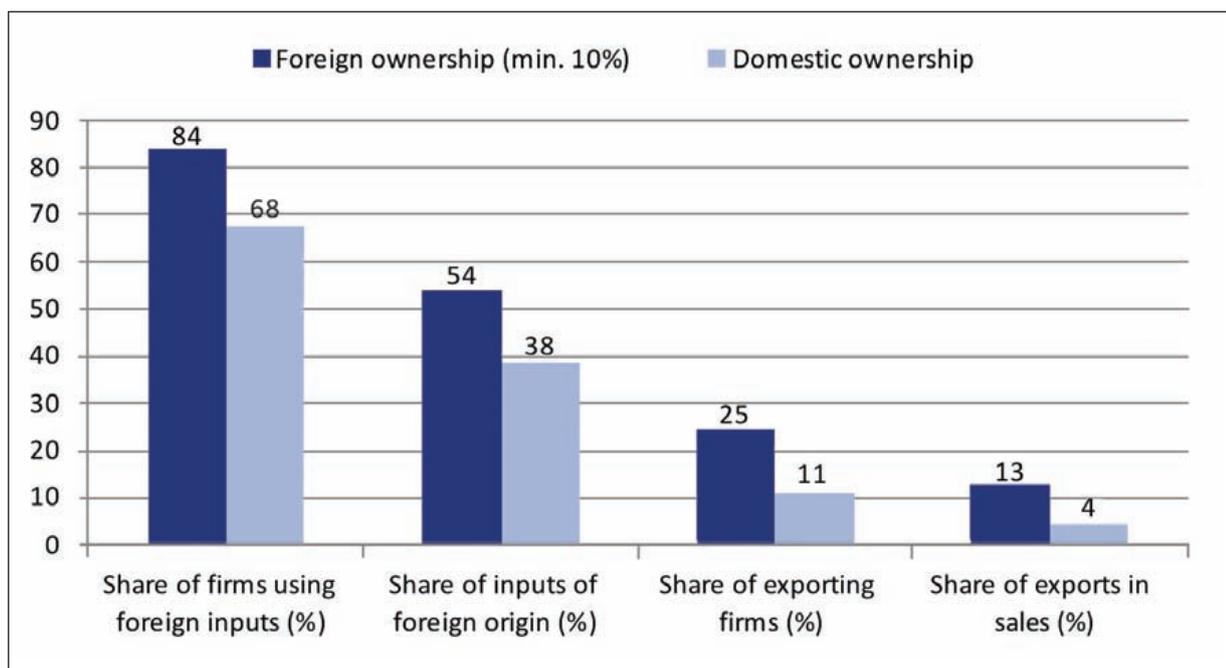
First, the entry or upgrading in GVCs is often linked to FDI. Besides direct employment effects, FDI can bring dynamic benefits linked to technology transfer or knowledge spillovers. Therefore, policy-makers should engage on policies aimed at both promoting FDI and strengthening the linkages of FDI with the domestic economy.

Figure 4 shows that firms in small economies with at least 10 per cent of foreign ownership tend to be more integrated in GVCs than domestically-owned firms. On average, 84 per cent of manufacturing firms with foreign participation source 54 per cent of inputs from abroad for their production. Such backward linkages are lower for purely domestically-owned firms, with 68 per cent of firms using foreign inputs in their production with the average share of foreign inputs being 38 per cent. Firms with foreign ownership participation are also more likely to export and tend to export a higher share of their sales compared to entirely domestically-owned firms.

A recent study by the United Nations Conference on Trade and Development (UNCTAD, 2014a) showed that most FDI inflows to small island developing states (SIDS) go to the mineral extraction sector and related processing activities. Smaller inflows go to the business, finance and tourism sectors. Since many small economies tend to be remote from major markets and of small size, they are less attractive for market seeking FDI. On the other hand, in several services industries such as tourism as well as IT and BPO, small size and remote location are less of a disadvantage.

After FDI, a second policy area of major importance to small economies is support to small and medium-sized enterprises. SMEs in small economies are less able to participate in international trade and GVCs compared to larger firms. Particular challenges that

**Figure 4: Trade Participation and Ownership of Firms in Small Economies**



Source: World Bank, World Enterprise Surveys

Note: Indicators are computed as simple average across 26 small economies.

SMEs face when trying to participate in GVCs include access to finance, workforce skills, market information and a restricted market size that prevents them from growing.

A way around this is for small economies to join other small economies through regional integration agreements such as CARICOM or the Pacific Island Countries Trade Agreement (PICTA). This could also attract larger companies or lead firms to organise production networks inside a region.

Another option is for small economies to increase their participation in GVCs by reducing their time-related trade costs. Efforts here require a focus on improving trade infrastructure and logistics services as well as on the implementation of the WTO's Trade Facilitation Agreement.

Maritime transport costs pose a real challenge for SIDS, which face relatively high transport costs due to small trade volumes and because several small economies, in particular Pacific islands, are relatively far from the global East–West container shipping corridor located in the Northern Hemisphere that carries 85 per cent of global containerised trade (UNCTAD, 2014b).

According to the UNCTAD liner shipping connectivity index (LSCI), small economies have a substantially lower shipping connectivity compared to the world average. Small economies had an average LSCI of 11.7 in 2014 (out of a

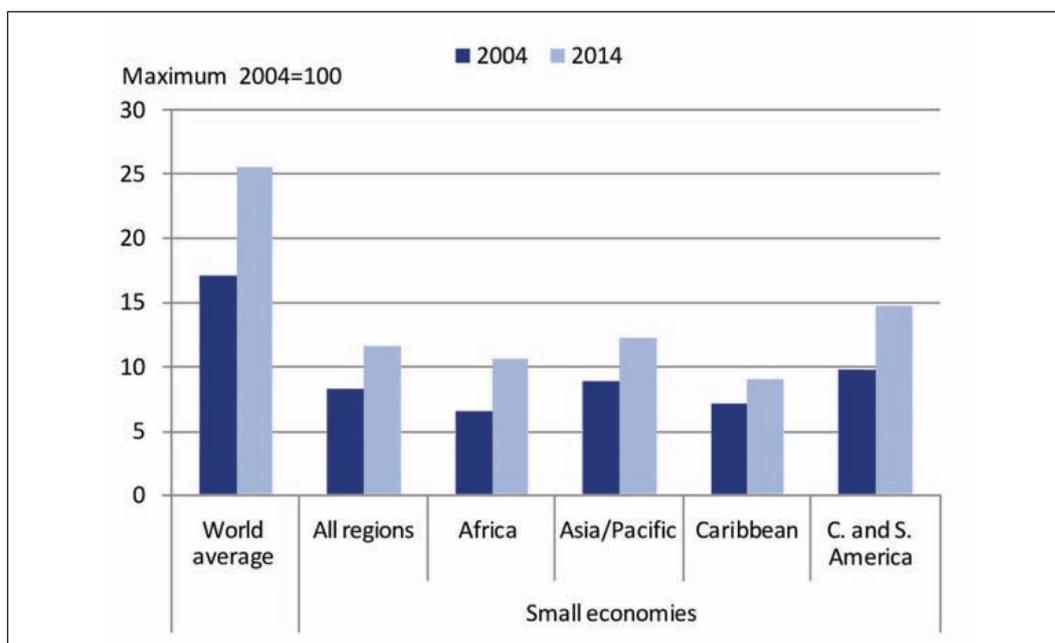
maximum of 100), which represents less than half of the index value of 25.5 for the world average. Small economies in all regions have, however, improved their connectivity between 2004 and 2014, with small economies in Central and South America being the best connected in terms of shipping (Figure 5).

Besides maritime transport, air transport is of particular importance to small economies because of their remoteness and because of their dependence on tourism. The existence of flight connections and the level of flight prices influence tourist numbers. Tourism arrivals by air are particularly high for the Caribbean islands and the three African small economies, namely, Mauritius, Seychelles and Cabo Verde (UNCTAD, 2014a).

Tourism and freight transport by air are mutually supportive as the majority of air cargo is actually shipped in the belly of passenger aircrafts. To take advantage of this complementarity between tourism and air transport, sound policy, including liberal bilateral Air Services Agreements, airport infrastructure and logistics services are required.

In the past, the remoteness of several small economies has hampered their connectivity to telecommunications networks. However, thanks to technological advances and increased demand, a number of projects have built submarine cables to deliver high-speed bandwidth connections to

Figure 5: Liner Shipping Connectivity Index for Small Economies by Region, 2004 and 2014



Source: UNCTADstat

Note: The regional aggregates of the liner shipping connectivity index are calculated using simple averages of 154 countries for the world average and of 31 countries in the case of small economies. The indicator is not available for Paraguay as it is landlocked. The LSCI measures the shipping connectivity of countries based on five components related to the deployment of container ships: (a) the number of ships; (b) the total container-carrying capacity of those ships; (c) the maximum vessel size; (d) the number of services; and (e) the number of companies that deploy container ships on services from and to a country's ports.

isolated communities thereby supporting socio-economic development. For instance, the Interchange Cable Network linking Vanuatu to Fiji has generated several positive socio-economic impacts in Vanuatu, allowing it to become the most competitive ICT hub in the South Pacific region.

### Concluding remarks

The increasing importance of GVCs offers opportunities to small economies as they can specialise in specific stages of the chain or take advantage of new services tasks created through the fragmentation of production. Improvements in transport and ICT infrastructure, the upgrading of laboratories and testing facilities, training to improve the skills of workers, export promotion initiatives or matchmaking between suppliers and buyers typically require both private and public investment. Targeted assistance and sound policy-making can indeed help the governments of small economies make the decisions that will allow SMEs and larger firms to take advantage of the opportunities which value chains offer. Policies for integrating into, moving up and realising additional gains from value chains are key factors given the dynamic nature of GVCs. But small economies, if supported with the right policies, can benefit from value chains in goods

and services trade and realise positive economic gains, no matter how small their size or how far away they are from their nearest customer.

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# International Trade Policy Section at the Commonwealth Secretariat

This Trade Hot Topic is brought out by the International Trade Policy (ITP) Section of the Trade Division of the Commonwealth Secretariat, which is the main intergovernmental agency of the Commonwealth – an association of 53 independent states, comprising large and small, developed and developing, landlocked and island economies – facilitating consultation and co-operation among member governments and countries in the common interest of their peoples and in the promotion of international consensus-building.

ITP is entrusted with the responsibilities of undertaking policy-oriented research and advocacy on trade and development issues and providing informed inputs into the related discourses involving Commonwealth members. The ITP approach is to scan the trade and development landscape for areas where orthodox approaches are ineffective or where there are public policy failures or gaps, and to seek heterodox approaches to address those. Its work plan is flexible to enable quick response to emerging issues in the international trading environment that impact particularly on highly vulnerable Commonwealth constituencies – least developed countries (LDCs), small states and sub-Saharan Africa.

## Scope of ITP Work

ITP undertakes activities principally in three broad areas:

- It supports Commonwealth developing members in their negotiation of multilateral and regional trade agreements that promote development friendly outcomes, notably their economic growth through expanded trade.
- It conducts policy research, consultations and advocacy to increase understanding of the changing international trading environment and of policy options for successful adaptation.
- It contributes to the processes involving the multilateral and bilateral trade regimes that advance more beneficial participation of Commonwealth developing country members, particularly, small states and LDCs and sub-Saharan Africa.

## ITP Recent Activities

ITPs most recent activities focus on assisting member states in their negotiations under the WTO's Doha Round and various regional trading arrangements, undertaking analytical research on a range of trade policy, emerging trade-related development issues, and supporting workshops/dialogues for facilitating exchange of ideas, disseminating informed inputs, and consensus-building on issues of interest to Commonwealth members.

## Selected Recent Meetings/Workshops Supported by ITP

12 -13 November 2015: Emerging Global and Regional Trade Issues for the Commonwealth Pacific Region, held in Tonga.

15 - 16 October 2015: Meeting for Commonwealth Caribbean Countries in Preparation for the 10th WTO Ministerial Conference, held in Bridgetown, Barbados.

29 September - 1 October 2015: Expert Group Meeting on Trade in Sustainable Fisheries, held in Geneva, Switzerland.

23 - 24 June 2015: Commonwealth Trade Symposium: 'Shaping a Global Trade Agenda for Development', held in Johannesburg, South Africa.

18 - 19 June 2015: Workshop for Commonwealth African Countries in Preparation for the 10th WTO Ministerial Conference, held in Kigali, Rwanda.

18 May 2015: Workshop on Post-Bali Issues and Preparation for the 10th WTO Ministerial Conference: A South Asia Perspective, held in Colombo, Sri Lanka.

25 - 26 March 2015: Consultative Meeting of Commonwealth Expert Group on Trade, held in Malta.

3 March 2015: Meeting of Market Access and Other Issues relevant to Small States in Geneva: Options in the Post-Bali Context, held in Geneva, Switzerland.

15-16 December 2014: International Conference on 'Mega Trading Blocs: Implications for Developing Countries' held in New Delhi, India

5-7 November 2014: 7th South Asia Economic Summit (SAES VII): Towards South Asia Economic Union and the Launch of the Publication on *Regional Integration in South Asia: Trends, Prospects and Challenges*, held in New Delhi, India

## Selected ITP Publications

Razzaque, M.A and Basnett Y., (eds) (2014). *Regional Integration in South Asia: Trends, Challenges and Prospects*, London: Commonwealth Secretariat

LDC IV Monitor (2014). *Implementation of Istanbul Programme of Action for LDCs*, London: Commonwealth Secretariat

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## Selected Ongoing Policy Research Projects

- Multilateral trade negotiations – specific issues for LDCs, SVEs and SSA
- The development impact of the Doha Round on least developed countries (LDCs)
- Aid for trade in small states and Sub-Saharan Africa
- Rise of emerging developing countries and implications for Sub-Saharan Africa and small vulnerable economies (SVEs)
- Mega trading blocs and implications for LDCs, SVEs and SSA
- Development issues under EPAs
- Trade in services
- Regional trading arrangements in South Asia and their implications
- Trade in services issues for small states and low-income countries
- Implementation of the Istanbul Programme of Action for LDCs
- Intra-Commonwealth trade & development cooperation
- Non-tariff barriers in South Asia and Sub-Saharan Africa
- Global value chains and the effective participation of LDCs, SVEs and SSA
- LDCs and SVEs in South-South trade

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# Trade Hot Topics

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