Deepening and Expanding Global Value Chain Participation across Asia and Europe

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This new era of globalisation, driven by the emergence of global value chains (GVCs), has resulted in a redistribution of global economic activity with Asian countries emerging as key players. Europe too has a rich network of production and has a large trade with Asia. This paper aims to provide the Asia–Europe Meeting with the facts and figures that are necessary to carry out an informed discussion on the possibility of deepening and expanding GVC participation across Asia and Europe in the coming years. It illustrates how the Indo-Pacific region fares in global GVC production statistics and the most apt means of joining and upgrading within GVCs. The paper sums up the policy recommendations that support an accrued connectivity across Asia and Europe, and globally.

Introduction

In today's world, final products no longer originate from one distinct production facility that engages in concept development, raw material sourcing, assembly, marketing, etc. (so-called global value chains or GVCs). These stages currently and predominantly take place in diverse locations either within or without the geographic proximity of the originator firm. The rationale behind such decisions is simple: 'economic efficiency and competitive advantage [considerations that are paired with the] transaction cost minimizing behaviour of firms' (Elms and Low, 2013, p. 314). The unbundling, fragmentation, or disaggregation of production has gained considerable traction in the past decades, with the advent of facilitated or instant communication, and the steadily increasing transportability of all things man-made across various logistic paths—air, land, and sea.

This novel *modus operandi* allows countries that would not have otherwise been able to develop, fund, supply, and control an independent and vertical chain of production to participate in the creation and distribution of wealth at those particular levels of production where their outputs are comparatively more advantageous than others'. Small developing countries have the opportunity to generate employment and capital, and join GVCs at those stages that best suit them, with the hope that given necessary policy changes and favourable capital and skill developments, they will eventually be able to expand the number of tasks and functions they perform, and climb up the GVC ladder to higher value-added echelons. The adage goes that once the low-hanging fruits of labour-intensive low-returns functions are picked, and the pull towards the upper-tiers of GVCs results in accrued competitiveness, streamlined productivity, and innovative sparks, then diversification is within reach and all participants to GVCs should be able to reap substantive benefits. That may be correct in theory, and in certain instances has even been demonstrated in practice, but only given a most perfect storm of conditions.

A combination of business acumen, access to finance, unimpeded trade and investment flows, and perhaps incipient efforts at coordinating or harmonising national regulatory spheres is indispensable to those producers and nations wanting to pen a masterful GVC success story. Such elements rarely occur naturally or concomitantly in the world of international trade. It is for this reason that successful integration in regional and global GVCs remains a pipeline dream for most modest participants to trade. Policymakers in such aspiring economies must therefore try their hardest to give their micro, small, and medium enterprises and multinational enterprises (MNEs) a fighting chance, and the most advisable action they can undertake is to observe, replicate, and not least innovate. This is to caution against unrealistic expectations that any and all countries may find their GVC 'calling' and trump micro- and macro-economic realities that have to date stood in the way of development and full participation to world trade. GVC participation does open the door towards development, but it is not panacea for difficult policy choices.

Most scholars describe GVC product development with the help of a convex bell curve or, in lay terms, a 'smiley face diagram' (World Economic Forum, 2012, p. 21). That is to say that on the left end of the bell curve, one finds the upper-tier activities such as standardisation, innovation, research and development, and design that bring in high-value added returns. On the lower and middle end of the curve, one finds labour-intensive activities such as manufacture and assembly that are associated with fewer returns. Finally, on the right end of the bell curve, logistics, marketing, and other brand activities occur that also bring in high returns. The challenge that most countries face is to reach either side of the bell curve and elevate themselves from the manufacturing and assembly positions in the diagram.

The Indo-Pacific region accounts for a notable share of GVC-issued products: 43 percent of intermediate goods (exports) and 38 percent (imports) that were traded internationally in 2013 came from this region. Yet, these products originated from only a handful of countries such as Singapore, Australia, Indonesia, Malaysia, South Korea, Japan, China, India, and Thailand. Ninety percent of registered trade flows can be accredited to these countries, whereas smaller participants such as Bangladesh and Cambodia account for the remaining and relatively high share of apparel exports and footwear (labour-intensive, low-return products). Generally, GVC participating countries are located all across the spectrum of development. However, in the Indo-Pacific region's case, one can notice that it is primarily the countries that are either highly developed or middle-income generating that are currently involved in GVC trade. This region principally exports electronics, automotive parts, agriculture products (primary and processed), apparel, and footwear.

With this in mind, one can affirm that the region is carving a place for itself in the world of GVC trade, but much as exports originating from the region penetrate global markets, final demand still arises from developed nations outside Asia. One event that contributed to a slight shift in demand from the global market to markets within Asia, however, is the 2008 Financial Crisis that saw Europe and America cowering under macroeconomic pressure. The crisis shifted ever so slightly demand for final products from developed countries outside Asia to the region itself to a tune of 7 percentage points (from 19 percent to 26 percent within 6 years, 2007 to 2013).

According to the United Nations Economic and Social Council for Asia and the Pacific (UNESCAP), the benefits that may arise out of GVC participation are 'multi-layered, ranging from the company level where GVCs can bolster productivity of participating enterprises and provide opportunities for the creation of higher skilled and better paid jobs, to the macro level with enhanced economic growth and higher per capita income' (UNESCAP, 2015, p. 103). It therefore appears highly desirable to engage in such fragmented trade, yet as was previously mentioned, a combination of factors must be present in order for firms to be able to successfully integrate these disaggregated ways of producing goods and services. An overwhelming amount of facilitating factors, however, lie strictly beyond the said firms' control and within the direct purview of governments and policymakers.

In spite of an almost unequivocal acknowledgement that engaging in GVC production is beneficial for economic growth, governments in particular maintain a certain degree of reluctance towards such participation inasmuch as recent history has shown that the more interconnected the global economy is, the faster do shocks spread across countries and regions. In other words, 'the systemic risk arising from exogenous shocks' (Elms and Low, 2013, p. 314) is carefully taken into account when governments devise their policies aimed at facilitating extra-regional GVC engagement. The bottom line, however, is that policymakers pursue development—not by any and all means but in a cogent, sustainable fashion. And GVC engagement done right can indeed bear fruits that extend beyond the originating firm and its affiliates and diffuse towards the society at large, in a way that furthers development. Yet, gains must be distributed evenly 'between countries, within countries, and among participating firms' (Elms and Low, 2013, p. 316).

Most economists and international trade scholars would agree that small and medium enterprises (SMEs) are 'the backbone' of national economies in the Indo-Pacific region. Beyond those, MNEs are evidently responsible for a grand part of national revenue and circulating capital. Both such entities are involved in GVC trade and they both face similar regulatory obstacles. However, the latter weigh heavier on the back of SMEs due to their very nature, size, and the magnitude of trade they undertake. It is for this reason that while GVC-enabling policy recommendations are meant to make trading easier for any economic actor that wishes to become involved in regional or extra-regional commerce, they specifically target those issues that are predominantly and disproportionately faced by SMEs.

When it comes to GVC participation, firms have three goals in mind: entrance, expansion, and upgrading. That is to say, they desire to gain access to GVCs, secure their presence and deepen it, and finally upgrade to higher value-added positions within the production chain. For these goals to be met, governments must be able to guarantee that the following prerequisites are fulfilled: (i) adequate hard infrastructure is present; (ii) physical and institutional connectivity is ensured; (iii) domestic regulatory conditions are favourable; and (iv) trade liberalisation and facilitation are pursued in an uncompromising manner. Additionally, a competitive business environment must be safeguarded, trade in services must be promoted, ICT development must be encouraged, innovation must be facilitated, intellectual property protection must be afforded adequate protection, foreign direct investment must be allowed in freely, and standards must be coordinated.

All of these items fall within the purview of governments: both domestic and of those countries that wish to see an increase in their partners' GVC participation—case in point: Asian countries and the European Union (EU).

The major takeaways for the Asia–Europe Meeting (ASEM) group of policymakers from the list presented above are that trade liberalisation, trade facilitation, and access to finance are key to a fruitful GVC participation. And these will be addressed in further detail.

Trade liberalisation is of paramount importance in facilitating access to GVCs inasmuch as intermediate products travel across borders numerous times, and each time they are subjected to tariffs that only act as barriers to their originator company's business. According to the Organisation for Economic Co-operation and Development (OECD), high tariffs continue to obfuscate trade in GVCs—particularly in developing countries, inasmuch as the water between declared and applied tariff is usually high. Additionally, each part, each intermediate product, and the final product itself fall within distinct and overlapping tariff categories, which means that, at the end of the day, the influence of tariffs is grossly magnified. Reducing and eliminating barriers to trade—whether they are tariffs, non-tariff measures, direct or indirect, and applied to goods, services or investment—must be made a priority.

Additionally, low-income countries are expected to reap benefits from **preferential agreements** which result in increased export volumes to their high-income trade partners. At a regional level, free trade agreements (FTAs) usually allow lower-middle income countries to significantly augment their export levels to intra-regional destinations. Particularly with regard to Indo-Pacific countries, it appears that signing an FTA with higher-income partners can guarantee access to extended markets both for intermediate and final products. Ultimately, 'the reduction of trade barriers from the perspectives of both exporters and importers are associated with an increase in global value chain–related exports from Asia-Pacific' (UNESCAP Secretariat Report, 2015, p. 15). And, according to UNESCAP, 'discounting other factors, global value chain export opportunities are much higher if countries have a regional trade agreement with each other' (UNESCAP Secretariat Report, 2015, p. 14).

An ASEAN–EU trade agreement is on the table, and the EU has completed two agreements in the region, with Singapore (2014) and Viet Nam (2015), that are awaiting ratification. In addition to this, the EU is also currently finalising talks with Malaysia, the Philippines, and Japan. Despite having launched discussions with both Thailand and Myanmar, however, the EU has suspended its efforts indefinitely.

Engaging in **trade facilitation**, that is, reducing trade costs can contribute to a streamlined access to GVCs. According to UNESCAP, regionally, East Asian countries enjoy the lowest trade costs, whereas, in spite of great improvement with respect to the figures collected in the mid-1990s, North and Central Asian states' trade costs are still, on average, three times higher; finally, the Pacific Islands states witness the highest obstacles to the free flow of trade. Data further shows that trade facilitation efforts result in great reduction to trade costs; quantitatively, a 1 percent augmentation in trade facilitation efforts may result in as much as a 2.3 percent decrease in trade costs. The most important indicator of a seamless trade is a reduced 'time to market' (UNESCAP, 2015a, pp. 53–55). Customs and their functioning are critical in ensuring that goods are transported across borders in a most time-efficient manner. Simplification, standardisation, and coordination are key goals in the effort to facilitate cross-border trade, and ensure access to GVCs. Realising these goals would have outstanding effects on SMEs in particular, as regardless of the size of a business the obstacles are of the same magnitude, and in practice and relatively speaking result in higher regulatory burdens on SMEs than on MNEs. This is confirmed by the OECD, according to which, we exist in 'a world where just-in-time delivery is the new norm, and in which transit is rapid and storage is expensive—[this is] a world where time is quite literally money' (OECD and World Bank Group, 2015, p. 60). Any efforts to reduce dwell time at the border, that is, any effort to facilitate merchandise passage through customs is beneficial to GVC trade.

In ASEAN, in particular, efforts have been made to 'reduce or eliminate border and behind-the-border regulatory barriers that impede trade, so as to achieve competitive, efficient and seamless movements of goods within the region' (EU-ASEAN Business Council, 2016, p. 3) within the context of ASEAN Economic Community implementation. The latter is set to facilitate the creation of a cohesive production base, pooling together the diverse types of comparative advantages that ASEAN member states possess and resulting in increased levels of competitiveness to meet the growing business opportunities originating outside the region.

Access to finance is crucial for SMEs that wish to join GVCs. Very often, these businesses face severe difficulties in their attempts to secure viable credit. SMEs are particularly exposed to such crippling constraints inasmuch as, in order to obtain formal bank loans, they must provide solid information about balance sheets and collateral—and the latter are hard to come by. Alternatively, SMEs resort to informal credit sources that are substantially more costly and less reliable than capital market borrowing. This is to say that for SMEs, there is no lesser evil: formal borrowing exposes them to requirements that are less favourable than those that apply to large companies, such as superior interest rates and shorter maturities, while informal lending is too risky. This issue is pervasive across Indo-Pacific economies and results in sluggish economies where job creation and social welfare are affected by a chronic lack of funds and overdraft facilities for the most dynamic of economic actors—SMEs.

Finally, and in an overarching manner, intra-regional and cross-regional **connectivity** must be facilitated. According to the EU-ASEAN Business Council, 'connectivity [...] refers to the physical, institutional and people-to-people linkages; [...] [w]hile physical connectivity refers to infrastructure, institutional connectivity is more multi-faceted—[i]t comprises among other things trade liberalization and facilitation, investment liberalization and facilitation, regional transport agreements and cross-border procedures.'

This is an issue that has been brought to the fore in the 2014 ASEM Chair Statement, where it was made clear that European and Indo-Pacific leaders understand 'the significance of connectivity between the two regions to economic prosperity and sustainable development and to promoting free and seamless movement of people, trade, investment, energy, information, knowledge and ideas, and greater institutional linkages. [Additionally, they] [...] called for the establishment of an integrated, sustainable, secure, efficient and convenient air, maritime and land transportation system, including intermodal solutions in and between Asia and Europe'.

In order for GVC participation to deepen and expand across Europe and Asia, governments, regional groupings, and supranational organisations must work in a manner that ensures that trade costs are low; that regulatory reforms favour cross-sector liberalisation; that financial cooperation results in easier access to credit for SMEs; that trade in services is not overlooked; that traffic-supporting infrastructure, both hard and soft, is in place; that human capital is nurtured and that intellectual property is protected and rewarded; and that development is pursued at any and all costs.

Beyond its prime geographical location, the Indo-Pacific region boasts growing economies, favourable demographic conditions, rising education levels, abundant human capital, relatively low production costs, and overall politically stable governing. For all of these reasons and more, European nations should work together with their Asian partners in a way that facilitates the latter's access to and growth within GVCs. Private enterprise is known to flourish if the right conditions are in place—so there is no need for governments to hold businesses by their hands. What they must do, however, is to ensure that the regulatory climate is indeed favourable to trade. Besides that, cost efficiency and comparative advantage will dictate the extent to which firms actually integrate GVCs.

Box: GVC for Landlocked Developing Countries

There are 10 landlocked developing countries (LLDCs) in Asia: Afghanistan, Bhutan, Kazakhstan, Kyrgyzstan, Lao PDR, Mongolia, Nepal, Tajikistan, Turkmenistan, and Uzbekistan. These countries face the same challenges as other developing nations and more, primarily due to their lack of access to maritime transportation routes.

Generally speaking, LLDCs are highly dependent on commodity exports; they face substantial trade costs due to poor infrastructure networks coupled with complex border procedures, and they lack adequate productive capacities and sufficient technological capabilities.

For LLDCs, the only route to development is through economic diversification and integration into regional and global value chains (GVCs). And for this to happen, local governments in concert with international agencies and private investors must work to implement trade facilitation programmes that would allow local producers to develop and make the best of their competitive advantages that are currently, where applicable, entirely obliterated by high trade costs.

A special outlook is needed under ASEM to bring the LLDCs into the GVC. The future of ASEM connectivity relies as much on fostering GVCs as in making the GVCs inclusive. The new international division of labour calls for a novel and coordinated approach in soft and hard infrastructure development to overcome participation constraints and to integrate the ASEM countries in the cross-regional GVCs.

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