

Asia–Europe Economic Connectivity Global Value Chain Structures in ASEM Region

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Foreword

The Economic Research Institute for ASEAN and East Asia (ERIA) is very pleased to present the Report on ‘Asia–Europe Economic Connectivity: Global Value Chain Structures in ASEM Region’ to the 8th ASEM Economic Ministers Meeting and to the ASEM Senior Officials Meeting on Trade and Industry.

ERIA has conducted several connectivity-related studies in the ASEM region, notably the ‘ASEM Connectivity Vision 2025’ and the ‘Brussels Report on ASEM Connectivity’. ERIA endeavours to support the ASEM chair and ASEM mechanisms through policy and research support to develop holistic connectivity for the ASEM region. Our connectivity-related research is also helping closer economic cooperation between Asia and Africa, and Asia and Europe.

It gives me great pleasure to share this expertise, through this report, with the wider ASEM community. We hope that this report will help the ASEM Leaders and ASEM Economic Ministers to prepare the road map for ASEM economic connectivity, which can be laid out at the 13th ASEM Summit in Cambodia in 2020.

ERIA will remain committed to providing all possible support and expertise that may be required to make ASEM a more responsive and creative platform for connectivity between Asia and Europe.

I believe that this report will make a significant contribution to the road map towards the 13th ASEM Summit in Cambodia in 2020.



Hidetoshi Nishimura
President
Economic Research Institute for ASEAN and East Asia

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Executive Summary

The Asia–Europe Meeting (ASEM) represents 62% of the global population, 57% of global gross domestic product, and 65% of global trade. Intraregional trade in goods and services, spurred by trade liberalisation and foreign direct investment, have proved to be a powerful engine for growth and participation in global value chains (GVCs).

GVCs have changed the Asia–Europe economic and political landscape in fundamental ways. Advances in technology, an enabling policy environment, and better and reliable connectivity have allowed businesses to internationalise their operations across multiple locations. ASEM GVCs are drivers of sustainable and inclusive growth in the region.

GVCs are extraordinarily present in Asia and Europe. Intraregional trade is the key factor driving economic growth, derived from intense trade activity in intermediate goods, both in Asia and the European Union. Nonetheless, trade in services is increasingly growing in importance. Trade in services is crucial for the smooth functioning of GVCs and has played a key role in the expansion of trade in Asia and Europe during the past few decades.

In the ASEM region GVCs have clustered around regional production hubs which are also top destinations for foreign direct investment (FDI). The key policy determinants of GVC trade in the ASEM region are deeper regional integration, trade liberalisation, improvements in the conduciveness of the business environment, and openness to FDI. Trade liberalisation has enabled Europe and Asia to participate in GVCs, significantly reducing tariff barriers to the trade of intermediate and final goods. Liberalisation of trade in services is a vital input for GVC production, adding value at each stage of the production process. Asian countries have been exceedingly progressive and have started to cover

General Agreement on Trade in Services (GATS)-plus provisions in trade deals with partner economies. Robust free trade agreement (FTA) activity that both Europe and Asia are negotiating are also important for the region.

Value-added services, stable macroeconomic conditions, simplified customs procedures, a predictable investment regime, reduced transport and telecommunication costs, and business-friendly reforms in the ASEM region are the mainstay of GVC trade and a key indicator of its complex production patterns.

Barriers to GVC integration are plentiful and still exist in several countries and sub-regions. ASEM leaders must pay special attention to small and medium-sized enterprises (SMEs) as they form the bulk of economic activity in Asia and Europe. Lack of managerial capabilities, inability to internalise technology, and behind-the-border barriers continue to impose higher costs on SMEs in competing with and connecting to GVCs. Non-tariff measures and services restrictiveness due to domestic regulations affect the competitiveness of Asian economies participating in the GVCs and prevent them from upgrading in the chain.

Trade and investment facilitation initiatives in ASEM should therefore be further expanded with the shared objectives of easing cross-border trade operations, improving the business climate, and closing the development divide through the firmer inclusion of the less-developed ASEM subregions. Asia–Europe Institutional Connectivity can help in overcoming these barriers. Deep and comprehensive FTAs with services, investment, and trade facilitation provisions can spur an enabling climate for further trade liberalisation.

The ASEM Economic Ministers' Meeting (EMM) can recognise the different business realities in Asia and Europe and rethink a complementary policy agenda for an open, transparent, and predictable trade and investment regime to leverage inclusive engagement in GVCs.

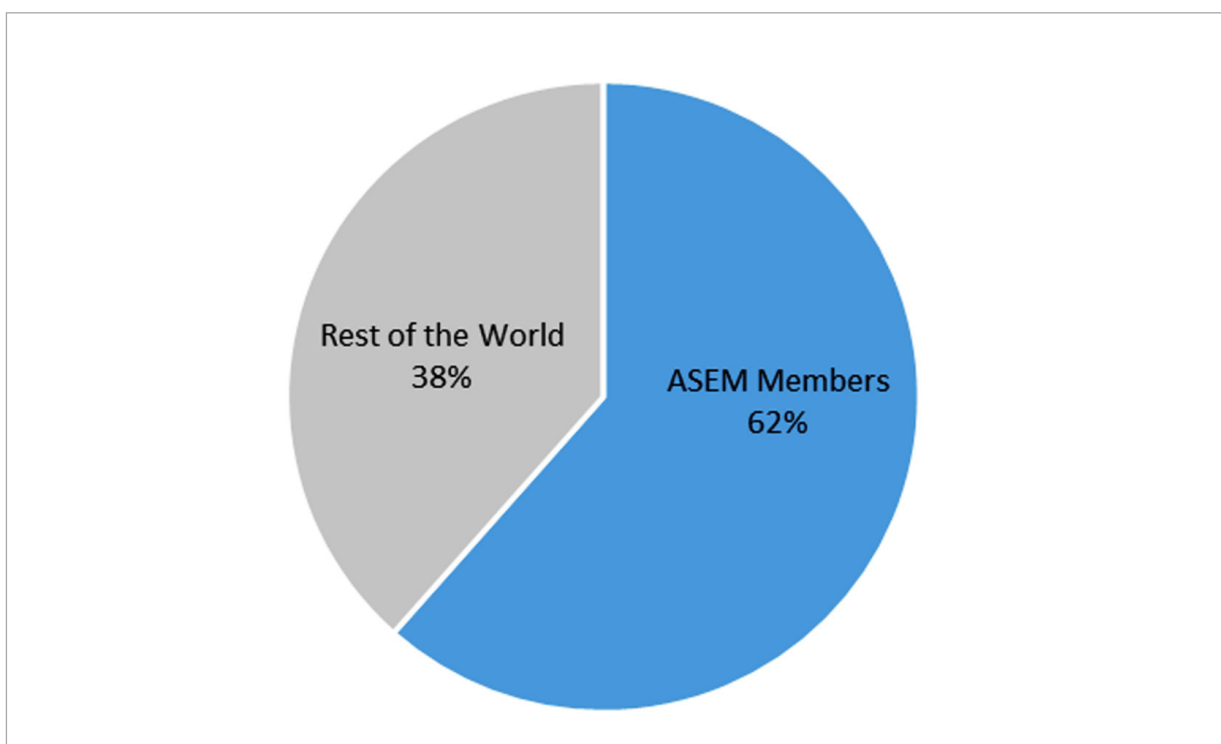
The ASEM EMM has the mandate and opportunity to promote the institutionalisation of public–private dialogue mechanisms to gather the views of different stakeholders that are affected or likely to be affected by increased economic and institutional connectivity between Europe and Asia. Besides a coordinated policy response on the issues listed above, engagement of different economic actors – including traders, logistics services providers, trade support institutions, investors, and border agencies – in the policy dialogue will ensure that the ASEM EMM follows the whole-of-supply-chain approach. This approach will ensure the expansion, inclusiveness, and sustainability of the GVC structures in the ASEM region.

Asia–Europe Economic Connectivity for Sustainable and Inclusive Growth: An Assessment of Global Value Chains in the ASEM Region

Introduction

The Asia–Europe Meeting (ASEM) encompasses a sizeable part of the global community (Figure 1). Since its inception in 1996, ASEM has played a key role as a forum for dialogue and cooperation in connecting Asia and Europe. It has a special role for fostering interregional relations. As a unique multilateral platform linking Asia and Europe, ASEM carries significant global weight. Representing 62% of the global population, ASEM’s combined strength and connectivity are a significant propeller of growth of both regions.

Figure 1: ASEM’s Share of the Global Population, 2017

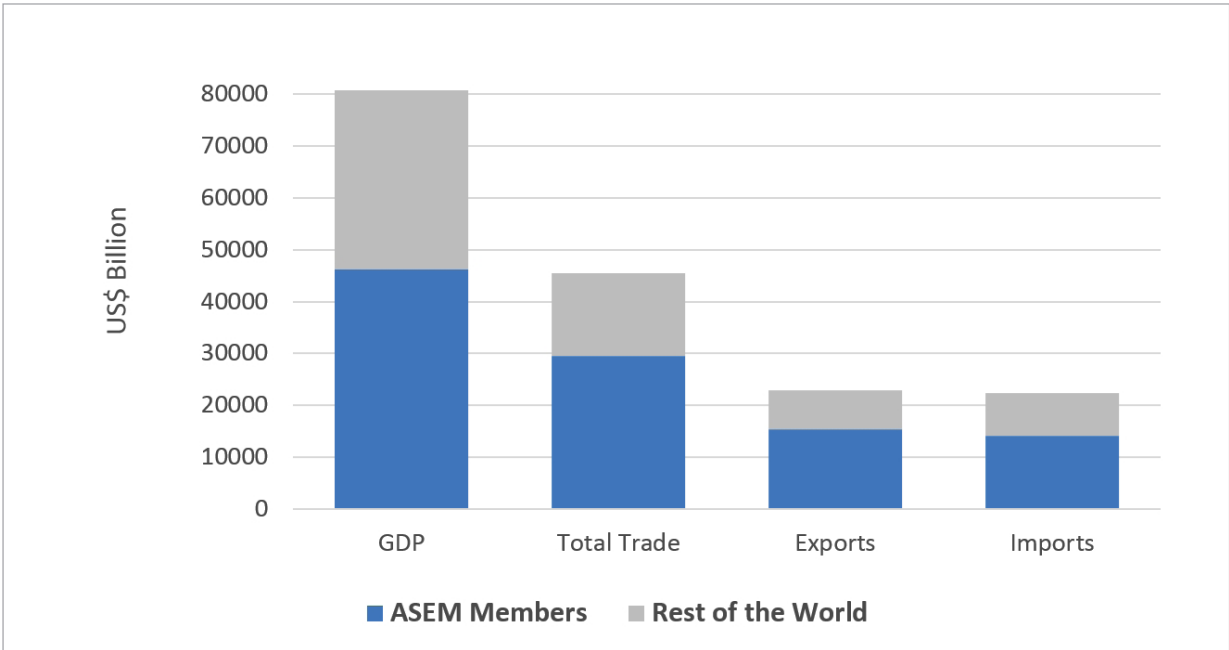


ASEM = Asia–Europe Meeting.

Source: World Bank (2018).

In 2017, ASEM constituted 57% of global gross domestic product and 65% of global trade. Asia and Europe have succeeded remarkably in harnessing the dynamics of modern trade and production patterns. Intra-regional trade in goods and services, spurred by trade liberalisation and foreign direct investment, have proved to be a powerful engine for growth and participation in global value chains (GVCs). Strengthened connectivity between Asia and Europe also relates to cooperation in improving soft infrastructure and simplifying the regulatory trade and investment environment. The ASEM economic indicators reflect the strength of Asia–Europe connectivity and the intensity of intra- and interregional trade and economic cooperation (Figure 2).

Figure 2: ASEM’s Share of Global Gross Domestic Product and Trade, 2017



ASEM = Asia–Europe Meeting, GDP = gross domestic product.

Source: World Bank (2018).

Asia–Europe Connectivity: Global Partnerships for Addressing Global Challenges

ASEM completed 20 years at the 11th ASEM Summit in Ulaanbaatar in July 2016. The year was significant for ASEM in more ways than just commemorating its 2 decades of existence and the laying out of a vision for ASEM connectivity into a third decade. At the 2016 ASEM Summit, ASEM leaders evaluated the outcomes of the institution and committed to setting forth a vision plan for ASEM that is responsive to changing regional and global needs. ASEM Leaders resolved to make the ASEM connectivity mechanisms committed towards a more connected Asia and Europe. Recognising the importance of deepening ASEM’s economic connectivity, leaders at the Mongolia summit renewed the ASEM Economic Ministers’ Meeting after a hiatus of 10 years.

The 7th ASEM Economic Ministers' Meeting was held in Seoul, Republic of Korea on 21–22 September 2017, chaired by H.E. Paik Ungyu, Minister of Trade, Industry and Energy of the Republic of Korea. It was attended by economic and trade ministers from 21 Asian countries (with Pakistan and the Philippines acting as Asian coordinators) and 30 European countries (coordinated by the European Commission and Estonia during its presidency of the Council of the European Union (EU), as well as the EU Trade Commissioner and the Deputy Secretary-General of the Association of Southeast Asian Nations (ASEAN). Representatives from the World Trade Organization, the Organisation for Economic Co-operation and Development (OECD), the United Nations Industrial Development Organization, and the Asian Development Bank also participated.

The theme of the meeting – Reconnecting Asia–Europe: Innovative Partnership for Inclusive Prosperity – reflected the important agenda of linking ASEM connectivity with the growth and prosperity of the two regions. The meeting discussions were held along three sub-themes: (i) facilitating and promoting trade and investment, (ii) strengthening economic connectivity, and (iii) sustainable and inclusive growth. Trade is the most visible face of ASEM connectivity, and the GVC structures between the two regions are important for understanding the pivotal role of trade in both regional and global growth. Therefore, a study of the GVC structure within the ASEM region is a useful policy tool for ASEM senior officials to undertake policy consultations and activities that would deepen the Asia–Europe economic connectivity and impel sustainable and inclusive growth in the ASEM region.

Europe has created seamless movement of goods, capital, and people in the EU. Countries outside the EU are also integrated with EU production networks through various trade agreements. Asia has been the growth centre of the global economy in the past decade. East Asia's production networks, particularly in machinery industries, are the most advanced in the world. Trade integration has increased rapidly within the world economy, particularly in Europe and Asia. GVCs have brought special benefits to firms in low-income and developing countries through sophisticated imported technology, know-how, a richer skill set, and above all, new opportunities. Small and medium-sized enterprises (SMEs) have particularly benefited from participation in GVCs.

GVCs have changed the Asia–Europe economic and political landscape in fundamental ways. Advances in technology and an enabling policy environment have allowed businesses to internationalise their operations across multiple locations to increase efficiency, lower costs, and speed up production. ASEAN and developing East Asia have proved that moving up in GVCs can be achieved through better and more reliable connectivity.

The Economic Research Institute for ASEAN and East Asia–OECD research on trade in value added (2015) suggests that while structural factors (such as the size of the economy or the distance to manufacturing hubs) are significant, trade and investment openness can play an important role in greater participation in GVCs. Logistics performance, hard and soft infrastructure, and good governance are equally important. All these factors are significant for the ASEM’s economic connectivity and for policy conversations on trade and investment among stakeholders.

ASEM GVCs are drivers of sustainable and inclusive growth in the region. GVCs are particularly beneficial for lower-income countries and smaller firms. Deeper integration into GVCs can assist them through reduced costs of internationalising their productions, regulatory compliance, and the search for profitable markets and reliable partners (International Trade Centre, 2017). SMEs can join an international value chain at different points and provide a variety of inputs.

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Spurring Trade and Investment Facilitation for Increased Global Value Chain Integration

Introduction

At the 11th Asia–Europe Meeting (ASEM) Summit, held in Mongolia in July 2016, ASEM leaders celebrated the 20th anniversary of ASEM as a forum of policy dialogue. During the event, they reaffirmed their ambition to enhance connectivity in all its dimensions across the two regions as Europe and Asia move towards the next decade. With the interdependence amongst economies in the two regions becoming increasingly intensified, the demand for connectivity in ASEM has grown stronger.

In a world where production models have dispersed into global value chains (GVCs), Asia and Europe have succeeded remarkably in harnessing the dynamics of modern trade and production patterns. In the two regions, intraregional trade in goods and services, spurred by trade liberalisation, and foreign direct investment (FDI) have proved to be a powerful engine of growth and participation in GVCs. In particular, the increasing shares of trade in intermediate goods, which dominates intra-regional trade in Asia and Europe, and value-added trade in services are significant indicators of how ASEM Partners have advantageously tapped the potential of competitive regional value chains. Since ASEM's inauguration in 1996, all groups of partner countries have significantly improved their trade balance, with all major regions progressively recording a trade surplus that rose from €80 billion in 1996 to €519 billion in 2014.

Yet, non-tariff measures (NTMs), restrictiveness in key services sectors, and the inability of FDI to generate technology and knowledge spillovers in the domestic economy have negatively affected the capacity of firms, especially small and medium-sized enterprises (SMEs) in less-developed ASEM Partners, to capture larger slices of the GVC pie. Facilitating trade, attracting foreign investment, and setting forth policies to allow its absorption have, hence, become key enablers for deepening the integration of firms into GVCs and narrowing the gap with better-performing ASEM Partners. Strengthened connectivity thus relates also to cooperation in improving soft

infrastructure and simplifying the regulatory trade and investment environment to make engagement in GVCs a success. Trade and investment facilitation initiatives in ASEM should then be further expanded with the shared objectives of easing cross-border trade operations, improving the business climate, and closing the development divide through the firmer inclusion of the less-developed ASEM subregions.

Therefore, ASEM leaders and trade policymakers need to take account of the different business realities in Asia and Europe and rethink a complementary policy agenda to have an open, transparent, and predictable trade and investment regime to leverage inclusive engagement in GVCs. The key initiatives in this regard include addressing NTMs in trade in goods, further liberalising trade in services, designing sound investment policies, and implementing regionally coordinated trade facilitation reforms.

Trends of Trade and FDI in ASEM in Recent Decades

The affirmation of GVCs has become the main paradigm of international trade, increasingly interconnecting economies around the world.

Trade has continued to spur economic growth and development, helping to improve human conditions around the world. Since 2006, world merchandise exports have increased in value by about 32%, totalling US\$16 trillion in 2016. At the same time, world exports of commercial services have accelerated by about 64%, reaching a total of US\$4.77 trillion in 2016 (World Trade Organization [WTO], 2017). Open trade and investment policies, greater access to resources and markets, reductions in transportation costs, and the information technology revolution have dramatically altered the world economy, resulting in increasing fragmentation of world production patterns into GVCs.

Within these patterns, raw materials, services, and parts and components are exchanged between countries before they are incorporated in the final products that are delivered to consumers all over the world. In such fragmented production models, where a single finished product results from manufacturing and assembly in multiple places, each step in the process adds value to the end product as a function of each country's competitive advantage.

Economies have become more interconnected and increasingly specialised in specific activities and stages of value chains, rather than in whole industries, trading large volumes of intermediate goods and services. It is estimated that since 1995, trade in intermediate goods has contributed more to the growth in total manufacturing trade than trade in final goods,

contributing 50.2% to its growth in the period 2009–2014 (World Bank et al., 2017). At present, GVCs account for 84% of the international production networks of multinational corporations (MNCs) and represent a dominant feature of world trade and investment. Through GVCs, countries trade more than just products. They also exchange know-how and technology, which flow internationally from one firm to another in the different stages of production. Especially for developing and least-developed countries (LDCs), participation in GVCs provides a vital opportunity for countries to leapfrog the development process as they have the potential to gain access to global networks while the total production costs are reduced. The GVC-driven success of nations like China and India well exemplifies the significant boost in a country's competitiveness that can be achieved by combining competitive costs of production with the expanding use of technology.

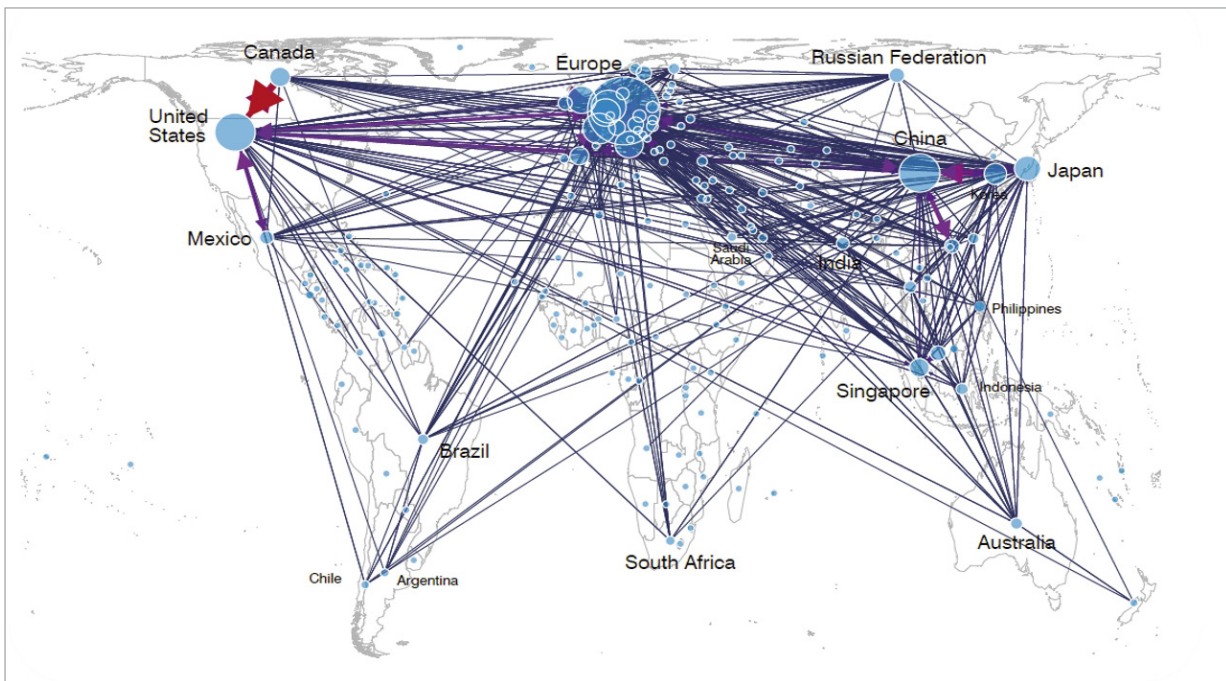
GVCs are extraordinarily present in ASEM, mainly triggered by the intense economic activity of intraregional trade in intermediate goods

While the rise of GVCs has spread across the globe, the expansion has been particularly robust amongst European and Asian emerging market economies, including those in the Association of Southeast Asian Nations (ASEAN), as depicted in Figure 1. Advanced European and Asian economies and developing Asian economies – particularly China and the Republic of Korea (henceforth, Korea) – have seized an increasingly greater share of the value added generated in GVCs, especially in high-tech manufacturing.

In Asia and Europe, intraregional trade is the key factor driving economic growth, showing how GVCs in both regions are mostly regional by nature. In Asia, the share of intraregional trade as a share of total trade increased to 57.3% in 2016 from an average of 55.8% during 2010–2015, whereas in Europe, the share amounted to 60% in 2016 (Asian Development Bank [ADB], 2017a; World Bank website).

This increase in intraregional trade has mainly derived from intense trade activity in intermediate goods. For instance, Chinese FDI into Southeast Asia has translated into an increase in the ratio of intermediate goods imports to total manufactured exports for these regional economies from 62.9% to 73.4% between 2000 and 2015 (ADB, 2017c). Likewise, Korean exports of intermediate goods to ASEAN represent around 70% of total Korea–ASEAN trade.

Figure 1: GVC Trade Flows



Source: ITC (2017a).

In the European Union (EU), intraregional trade in intermediate goods represents on average 50% of the total trade in goods and has seen the rising participation of Central and Eastern European (CEE). Especially since joining the EU, lower-cost Central and Eastern European countries have mastered intensive regional trade linkages with other EU member states, reflecting the fact that adopting EU regulations has been particularly conducive to the development of trade ties within European GVCs. In the CEE region, the share of intermediate goods in total trade peaked in Hungary (61.9%), while the Czech Republic, Bulgaria, Slovakia, and Romania have each reported shares within the range of 58.0%–60.0% (Eurostat, 2017). This suggests that these countries have become important suppliers of intermediate goods to key EU producers, or have assembled goods for other EU economies to be shipped to final consumers within and outside Europe. Moreover, a study by the European Central Bank (2013) shows that CEE countries have started to establish their own value chains. Poland and the Czech Republic stand out as increasingly upstream-position economies, driving consistent flows of FDI within the CEE region. Germany is by far the main trading partner of CEE economies, comprising most of the trade involving intermediate goods. Between 1995 and 2015, the share of intermediate goods in total Eastern European exports to Germany fluctuated at around 60%. In the same period, Germany accounted for 30% of Poland's exports and 32% of the Czech Republic's exports, whereas it accounted for 27% of Poland's imports of manufacturing inputs and 32% of the Czech Republic's imports – with trade mainly concentrated on medium-technology intermediates related to chemicals, machinery and equipment, and motor vehicles (World Bank et al. 2017).

Manufactured goods dominate trade between Asia and Europe; nonetheless, trade in services is increasingly growing in importance

In 2017, China, Japan, Korea, and India were amongst the EU's top 10 trading partners, representing, respectively, 16.9%, 3.5%, and 2.7% of the EU's total trade (Figure 2). The ASEAN Member States collectively were the fourth largest trade partner of the EU, together with Russia, representing 6.2% of the EU's total trade. India was the EU's ninth biggest economic partner, equalling 2.3% of the EU's overall trade, whereas Bangladesh and Pakistan overall accounted for less than 0.9% of the EU's total trading activity.

Manufactured goods represent the largest share of trade between Asia and Europe. At present, China is the EU's biggest source of imports and its second-biggest export market. In 2017, China retained a share of 11% in extra-EU exports, worth €198 billion, making it the EU's second most important trade partner behind the United States. For extra-EU imports, China was the EU's largest partner, representing 20% of all EU-imported goods, amounting to €380 billion. From 2008 to 2017, import trade between the EU and China massively increased, with imports from China nearly doubling from €200 billion in 2008 to almost €400 billion in 2017. The main categories driving imports from China were machinery and vehicles (representing half of total imported goods from China), electronic equipment, other manufactured goods, and chemicals. The Netherlands equalled 30.4% of all EU imports from China, followed by Germany, the United Kingdom, Italy, and France (Eurostat, 2018). Following a similar pattern, the EU and ASEAN countries have significantly consolidated their bilateral trading activity over the last decade. The EU represents ASEAN's second largest trading partner after China, accounting for around 13% of ASEAN trade. As in the case of China, the EU has increased its imports from ASEAN economies, totalling €136 billion in 2017, whereas its exports to Southeast Asia amounted to €91 billion in the same year. Trade in services is also crucial for the smooth functioning of GVCs and has played a key role in the expansion of trade in Asia and Europe during the past few decades (Figure 3). Europe performs well in trading services with its Asian trading partners despite the value of trade in services being significantly lower than that of trade in goods. From 2000 to 2016 the EU's services transactions with its trading partners grew each year at a relatively fast pace, with growth peaking at 11.3% in 2015. It is worth noting that during the last five years for which data are available (2012–2016), international trade in services only accounted for approximately 30% of all EU transactions in goods and services with third countries. However, growth of EU international trade in services was higher than for international trade in goods, suggesting that international

transactions in services have become increasingly important for the performance of the European economy. In 2016, the largest surpluses of EU in trade in services were recorded with Russia, Japan, Australia, and China. Other business services and transport represented the bulk of services exported by the EU (Eurostat, 2018).

Figure 2: EU Trade in Goods with Selected Non-EU ASEM Members in 2017 (€ billion)

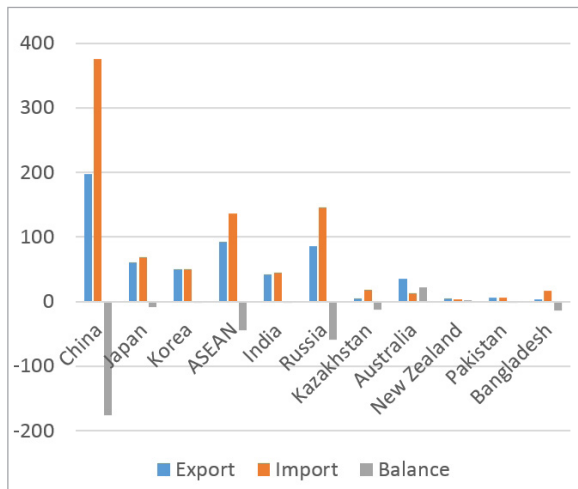
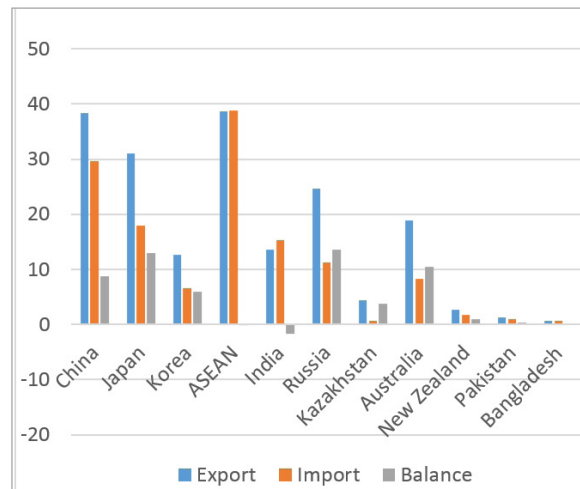


Figure 3: EU Trade in Services with Selected Non-EU ASEM Members in 2016 (€ billion)



Source: Eurostat, European Commission website (2018).

In ASEM GVCs have clustered around regional production hubs. The distribution of value added in the production process amongst economies in regional hubs is dynamic

The regional character of international value chains, measured by the share of trade in parts and components in bilateral trade, is further visible in the production processes clustered around regional hubs – China and Germany in Asia and Europe, respectively. These production champions constitute two of the three main global hubs of trade in parts and components, together with the United States. The changing pattern of GVC trade in Asia is associated with a shift in the Chinese production model, which has evolved from merely assembling components to capturing higher value in key industries, such as the electronics, automotive, and high-end chemical industries. China is steadily climbing the value ladder of its production chains, following the model of higher domestic value added and technological innovation, as witnessed first in Japan and, subsequently, in Korea. This implies the development of more technologically sophisticated regional patterns in East Asia, which is propelling a new phase of trade growth across Asia, especially for countries in the region with larger cost advantages.

For instance, as Chinese domestic firms have captured larger market shares in more competitive industries, some of China's GVC production stages – especially, but not only, labour-intensive ones – are progressively migrating towards lower-cost countries in South Asia and Southeast Asia. This has also been made possible by the entry into force of the ASEAN–China Free Trade Agreement, which has progressively removed 90% of tariffs, first with the six more advanced ASEAN nations and later with the group of Cambodia, Lao PDR, Myanmar, and Viet Nam. South Asia is also strengthening its regional value chain links with China, with the latter increasingly relying on India for its smartphone and heavy-equipment production, as shown by the increasing scale of Chinese investment in manufacturing facilities.

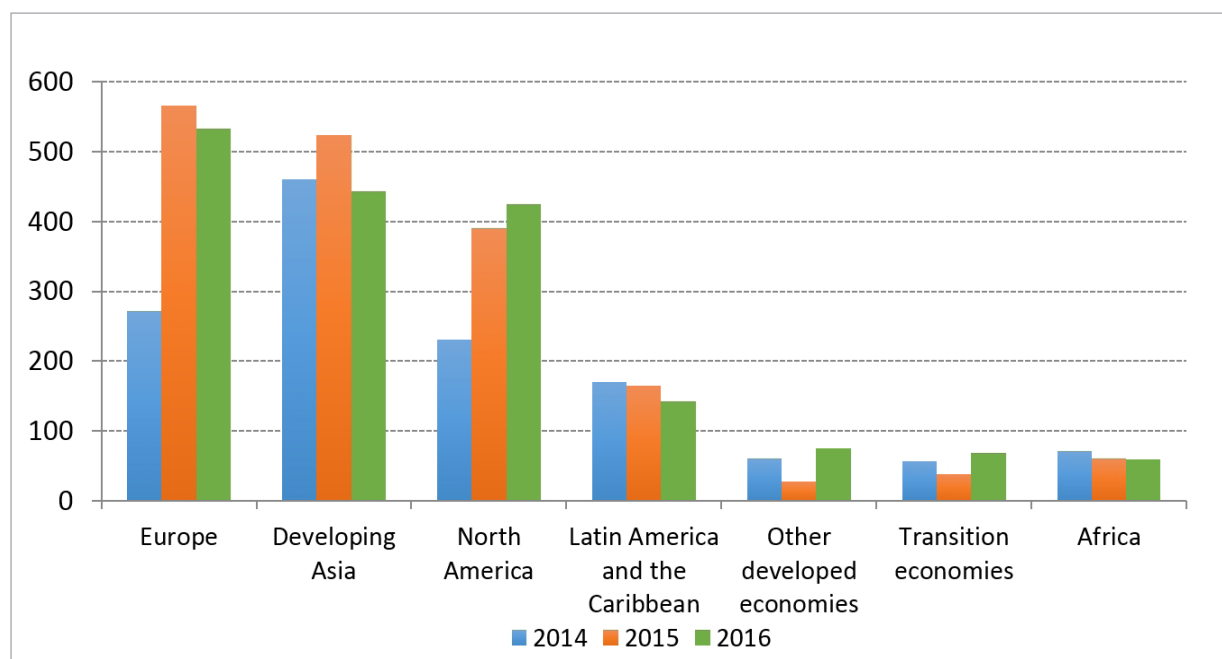
Europe and Asia are the world's top destinations for FDI. In Asia, the strong GVC–FDI connection has mainly triggered intraregional foreign investment

Available data show that the global FDI stock grew massively from US\$700 billion in 1980, representing 7% of global gross domestic product (GDP), to almost US\$25 trillion in 2015, accounting for 34% of global GDP. Particularly relevant for developing economies, FDI flows have remained the largest and least volatile of all their external sources of financing between 2007 and 2016, totalling more than US\$600 billion in 2016 (UNCTAD, 2017a). Although in 2017 global flows of FDI fell by 17% from the previous year to an estimated US\$1.52 trillion, FDI to developing economies remained stable at an estimated US\$653 billion.

Despite experiencing a decline in 2016, Asia and Europe still hold as striking magnets for FDI, remaining the world's top recipient destinations of FDI (Figure 4). In 2016, FDI inflows to Asia were recorded at US\$492 billion. Developing Asia's share of global FDI accounted for one-third of total FDI inflows, increasing from 12% in 2001 to 28% in 2016 and earning Asia the position of the second largest recipient of foreign investment globally. Notwithstanding political uncertainties and the United Kingdom's decision to exit the EU, Europe remained the largest recipient of foreign investment in 2016, recording FDI inflows of US\$533 billion.

Intraregional FDI continues to strengthen, and the intraregional share of inward FDI to Asia increased from 32% in 2007 to 55% in 2016. In the same year, FDI from Hong Kong represented the lion's share of intra-Asian FDI (nearly 37%), followed by Singapore, Japan, and China, each accounting for approximately 16% of intraregional investment (ADB, 2017a). Although East Asia still attracts more than half of the FDI inflows to Asia, in 2016 it saw a downturn in inward FDI, with Southeast Asia following the same slightly declining trend. Conversely, South Asia witnessed a marginal increase in foreign investment, where inward FDI to Pakistan and Bangladesh saw modest growth. Similarly, Central Asia attracted US\$5.1 billion more of FDI in 2016 in comparison to the previous year, with Kazakhstan capturing the largest slice (40%).

Figure 4: FDI Inflows by Region, 2014–2016
(US\$ billion)



Source: UNCTAD, 2017a.

The largest part (roughly 56%) of intraregional FDI in Asia comes in the form of greenfield investment (mostly in the manufacturing sector) due to the sound link between FDI and GVC activity. In contrast, intraregional merger and acquisition (M&A) concentrates mainly in services investment, although intra-Asia M&A in manufacturing is increasing, as seen in Thailand and Viet Nam. The largest recipient industry for Asian investments is real estate (19% of total outward FDI), a mixture of both manufacturing and services, primarily channelled through greenfield investment. The second largest is financial services (13%), driven by M&A.

The intraregional nature of FDI has been driven by a massive rise in China's outward-oriented FDI in manufacturing in Asia – the value of China's greenfield FDI into Southeast Asia and South Asia nearly doubled from US\$26.6 billion in the period 2005–2010 to US\$50.2 billion in 2010–2015, with Indonesia, India, Malaysia, Thailand, and Cambodia representing the largest recipients. Manufacturing FDI inflows from more developed economies in East Asia, namely Japan and Korea, have also continued to grow in Southeast Asia. For instance, in 2016, more than 50% of Korea's FDI in the ASEAN region went to manufacturing, dominated by investments in Viet Nam (ASEAN and UNCTAD, 2017). Likewise, Japanese FDI into manufacturing activities has increased in ASEAN, from US\$7.9 billion in 2015 to US\$23.8 billion in 2016, reflecting the increasing expansion of GVC networks of Japanese manufacturing firms in the automobile parts and electronic equipment sectors in the Southeast Asian region. India has also seen an increasing Japanese presence, with Japan announcing in 2017 to set up 11 industrial parks in different Indian states.

The complex pattern of FDI activity is also visible in the rise of intra subregional FDI, with Thailand as a notable example in Southeast Asia. Despite the global financial crisis, Thailand's outward FDI has been consistently expanding, from US\$2.3 billion in 2007 to US\$17.2 billion in 2016, 84% of which was within the ASEAN region. The surge has been mainly catalysed by greenfield investment in the manufacturing sector in neighbouring countries, with Viet Nam capturing almost one-third of the total in 2016.

While FDI in Asia has shown growing regional dynamics, the EU reconfirmed itself as the largest investor in ASEAN in 2016, driving US\$31 billion of FDI inflows in the region – more than doubling from the past decade – 85% of which was substantively captured by investment in finance and other services. The attraction of foreign investment has been catalysed through the proliferation of economic zones of various types in ASEAN, which have slowly evolved from simple industrial estates providing basic facilities to new-generation science and technology parks facilitating science and research activities. With one of the world's most open investment regimes, Europe stands as the largest source and recipient of FDI in the global economy, accounting for roughly 33% of global FDI flows. Financial and insurance activities represent the highest share of both inward and outward flows of EU FDI. Creating almost 260,000 new jobs in 2016 (Ernst & Young, 2017), the scale and nature of projects undertaken by investors in Europe (with sales and marketing, manufacturing, and logistics on the podium) well depict the magnitude of the digital transformation happening in the dynamic European economy.

Key Policy Determinants of GVC Trade in ASEM

Deeper regional integration, trade liberalisation, improvements in the conduciveness of the business environment, and openness to FDI have resulted in the remarkable participation of ASEM Partners' economies into regional and GVCs. What follows is an assessment of the major determinants that have dominated the policy space in Asia and Europe to foster regional and global trade connectivity through integration into regional and GVCs. Given the complexity of global trade patterns, these domains require careful attention by ASEM leaders, as well as strategic thinking to advance smart solutions for the corresponding policy challenges that have arisen. The challenge, in particular, is to improve connectivity between the different subregions of Asia (e.g. South Asia and lower-income countries in Southeast Asia) and, in the process, to unlock the potential of the countries and regions that link Europe and Asia, such as Central Asia.

Trade liberalisation has enabled Europe and Asia to participate in GVCs, significantly reducing tariff barriers to the trade of intermediate and final goods.

As seen in Asia and Europe, trade and investment connectivity has been mainly consolidated in regional value chains and their plug-in into GVCs. With production clustered around regional hubs, the rise of ‘factory Asia’ and ‘factory Europe’ has become the paradigmatic model of trade and development policies in GVCs. Manufacturing processes that used to be performed in single factories have been fragmented in different places in the two regions, taking advantage of the regional comparative advantages and closeness to headquarter economies (Baldwin, 2012).

Trade liberalisation efforts, which drive the seamless growth of intraregional trade in parts and components, have spurred the GVC participation of ASEM Partners by increasing the competitiveness of domestic firms within value chains. Liberalisation of trade in goods has resulted in historically low tariffs of about 8% in developing Asia and of 2% on average in the EU (see ADB [2017c] and World Bank Open Data). This suggests that removing tariffs on intermediate goods has lowered transactions costs for businesses and enhanced the profitability of domestic firms sourcing inputs from foreign suppliers.

Complementarily, liberalisation of trade in services has also been progressively attained at different levels. In fact, services have become vital inputs to GVC production, adding value at each stage of the production process. Moving beyond multilateral commitments made in the General Agreement on Trade in Services (GATS), Asian countries have increasingly pursued services liberalisation at the bilateral level and started to cover GATS-plus provisions in trade deals with partner economies. This means that more emphasis is being placed on services trade liberalisation going beyond WTO commitments in relation to subsectors and horizontal regulations.

Investment liberalisation has also been a major driver of GVC growth, spurring the expansion of the operations of MNCs through unilateral, bilateral, and regional investment arrangements. Unilateral policies in developing Asia have been sought to liberalise the investment regime and attract global and regional foreign investors. Provisions disciplining investment have also been gradually incorporated in bilateral and regional trade agreements with partner countries to encourage FDI by offering certain guarantees and protections. The inclusion of investment in the scope of negotiations of trade agreements has, thus, provided additional opportunities to liberalise investment and develop complementary goods, services, and investment disciplines that can be applied to increasingly interconnected trade and investment activities.

In ASEM, trade liberalisation has been driven by robust free trade agreement (FTA) activity, which is intensifying in dimension and scope

Trade liberalisation has primarily been driven by the progressive proliferation of FTAs in Asia and Europe in the past two decades, leading to lower tariffs on traded goods and less protectionist measures applied by trading partners.

In Europe, the removal of tariffs and quotas has been progressively pursued on a regional scale in the last 60 years, evolving from a free trade area to a single market where goods, capital, services, and persons can move freely within the EU territory. As a result, EU member states as a whole have traded goods more with each other than with countries outside the EU (except for the United Kingdom, Malta, and Cyprus). However, there is a relatively large variation amongst member states, ranging from almost 85% of Slovakia's total exports of goods going to other EU member states to under 42% of Malta's total goods exports in 2016 (Eurostat, 2017).

In its 'Trade for All' vision, unveiled in 2014, the EU gave new life to its FTA strategy, reinvigorating its engagement in Asia through a number of bilateral FTAs. The EU–Korea FTA, entered into force in 2016, is the most ambitious trade agreement ever concluded by the EU, and it triggered the conclusion of the negotiations of the EU–Japan FTA in December 2017. The EU also concluded negotiations of an FTA (as well as an investment protection agreement) with Singapore in 2014, considering it as a stepping stone to greater engagement in Southeast Asia. The EU has also re-opened or is planning to launch new FTA negotiations with other ASEAN partners, notably Indonesia, the Philippines, Malaysia, and Thailand. Bilateral FTAs with single ASEAN partners might also revamp trade talks to advance the region-to-region trade and investment agreement with ASEAN as a whole, which was abandoned after failed negotiations in previous years. Advancing trade and investment agreements with India and China has also been set as a regional priority for the EU, as well as launching negotiations of FTAs with Australia and New Zealand to deepen integration with Asia–Pacific value chains.

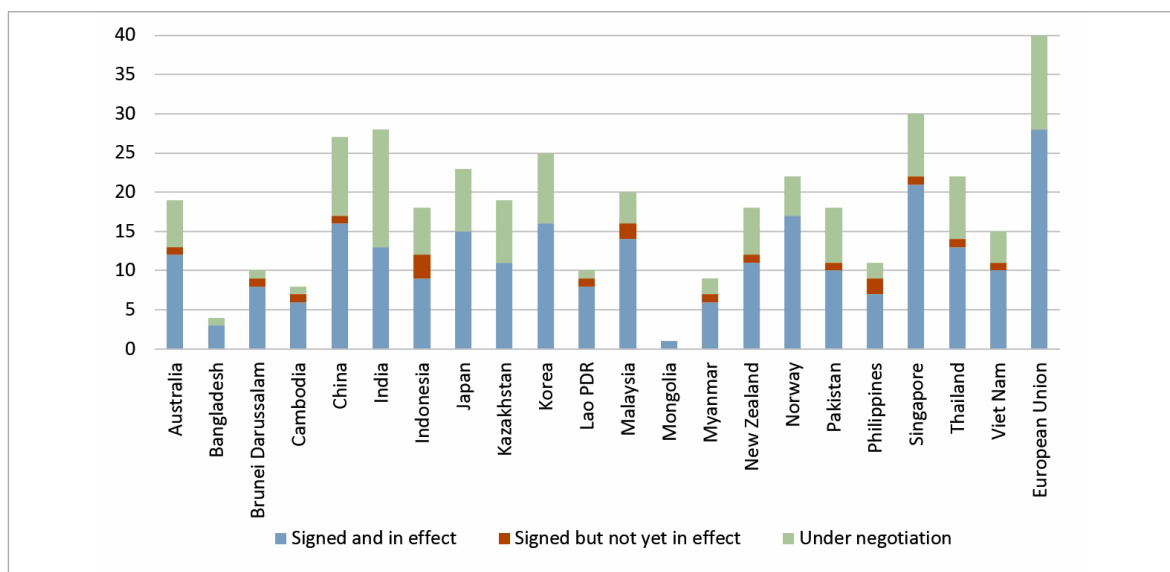
Although Asia was a relative novice to FTAs before the 2000s, the region has witnessed an explosion of such agreements in the last decade, and today it is at the forefront of world FTA activity. In Asia, FTA-led regionalism has been pursued as a successful trade policy and outward-oriented development strategy to support sophisticated and dynamic production networks. A blanket of FTAs – spearheaded by China, Japan, and Korea, followed by ASEAN countries – has led to a significant increase in intraregional trade, particularly in parts and components, and will continue to expand further through regional liberalisation brought by FTAs. Open regionalism has also driven Asian countries to sign FTAs with partners

outside Asia to ensure market access to new destinations. Likewise, the EU has embarked upon an ambitious trade agenda pursuing deeper trade connectivity through deep and comprehensive FTAs since 2004. Current FTA negotiations involve Myanmar, Indonesia, Thailand, and the Philippines.

The infiltration of FTAs is showing no sign of slowing down, especially amid the uncertainties due to rising nationalistic narratives by global trade leaders. In 2017 alone, 151 FTAs were in effect and another 169 under negotiation or proposed in Asia alone. However, there are significant gaps between different subregions depending on their development levels and priorities.

In 2017, Singapore – the most FTA-inclined nation in Southeast Asia – had 30 FTAs in force or under negotiation (including those signed by the ASEAN bloc), followed by Malaysia with 21 FTAs and Viet Nam with 15. On the other hand, Myanmar and Cambodia have less FTA activity, which enables them to apply more protectionist principles and safeguard their domestic markets. As a bloc, ASEAN has signed comprehensive FTAs with all major global powers, including China, India, Japan, and Korea, covering not only goods but also regulations on services, intellectual property protection, and competition policy. In South Asia, India leads FTA activity with 29 FTAs in force or under negotiation, whereas Bangladesh lags behind with just 6 FTAs. In East Asia, China, Japan, and Korea are considerably aligned in terms of FTA activity, with the three having an average of 25 FTAs in force or under negotiation. Mongolia, on the other hand, is completely disentangled from FTA activity (Figure 5).

**Figure 5: Breakdown of FTAs for Selected ASEM Partners
(number of FTAs)**



Lao PDR = Lao People’s Democratic Republic, FTA = free trade agreement.

Source: Statistics from ADB Asia Regional Integration Center, 2017.

The new generation of modern FTAs that both Europe and Asia are negotiating are deep and comprehensive by nature, going beyond the mere liberalisation of trade in goods

Modern FTAs in fact cover not only the removal of tariffs on trade in goods but also trade in services and investment provisions, customs and trade facilitation, cooperation to remove burdensome NTMs, intellectual property protection, competition policy, and, in some cases, sustainable development provisions. These deep agreements have been motivated by the international expansion of production networks since harmonisation in certain national policies facilitates cross-border business activities and allows GVCs to work smoothly.

The EU is at the forefront of negotiating deep and comprehensive FTAs covering a number of policy domains and is also increasingly relying on the so-called ‘conditionality clauses’ to ensure that trading partners commit to enforcing certain human, environmental, and labour rights as a condition to access the EU market. The text of the EU–Viet Nam FTA, concluded in 2016 and expected to enter into force in 2018, is a notable example of this enhanced cooperation on the social dimension in an FTA, enshrined in a dedicated chapter on trade and sustainable development.

Asia is also following the same trend, with an increasing number of deep and comprehensive FTAs in the pipeline. As of December 2016, in Asia, 34 FTAs contained an investment chapter, while four FTAs reported investment provisions in their services chapters. Trade facilitation provisions have also tended to have their own chapters in FTAs, as in the case of customs procedures, e-commerce, standards and sanitary and phytosanitary measures (SPS).

Trade in services has become increasingly important in Europe and Asia. At present, the relative weight of services is more pronounced amongst high-income ASEM countries.

Services are crucial to the smooth functioning of GVCs, and they have played a key role in the expansion in trade in Asia and Europe during the past few decades, providing new opportunities to seize larger slices of the GVC pie. Europe and Asia well reflect this intensifying trend in international production networks, where the embedding of the services sector in GVCs has become crucial for capturing a larger number of higher-value tasks and activities feeding into these chains.

The provision of services contributes to a substantial share of the EU’s economic growth and accounts for more than 50% of GDP in each of the member states. The latest data available show that in 2016, the EU was the largest world exporter and importer of services, accounting for 23.9% of global services exports and 20.8% of global services imports (Eurostat, 2018).

The relative weight of services was larger, on average, amongst European ASEM Partners (73.5% of total value added) than in any of the Asian ASEM Partners except for Singapore (75%). Nonetheless, even in Asia, the services component in value-added production is expanding, enabling domestic firms to lower the cost of doing business and increase their international competitiveness. In value-added terms, services accounted for almost 61% of the total value added in East Asia in 2016, 55% in South Asia, 50% in Southeast Asia, 73% in Australia, and 61% in Kazakhstan (World Bank Open Data).

Other than goods, value-added services have become a pillar of GVC trade and a key indicator of its complex production patterns – a phenomenon well evident in a number of ASEM economies moving upwards in GVCs.

In GVCs, manufacturing goes beyond the pure production of goods to embedded service-related activities – whether they are meant for final consumption or as inputs in the production of goods or other services. The very existence and functioning of GVCs are heavily dependent on improvements in key services sectors, such as transport, logistics, distribution, information and communication technology (ICT), and other professional services that make it possible to fragment and coordinate production. Integrating services into their business strategies has, therefore, enabled manufacturing firms to improve their performance and competitiveness and upgrade and differentiate their products in the presence of global competition.

Evidence shows that the share of services in value-added trade is substantial and steadily increasing in GVCs. While services as a share of total world gross exports have remained around 20% since the 1980s, services in value-added terms have increased from below 30% to more than 40% in 2010. Moreover, when looking at the decomposition of services value added in exports into domestic and foreign value added, it is reported that the increasing share of services in value-added trade was driven by services embodied in other exports. In the period 1995–2011, more than 65% of the growth of value-added services was determined by an increase in services embodied in other exports (World Bank, OECD, IDE–JETRO, UIBE, 2017).

The growing importance of services value added in overall GVC production is well evident in ASEM. Incorporating increasing shares of value added from services has enabled a number of ASEM economies to capture a larger share of value added in GVCs and move towards a more upstream position in production. In Asia, Japan, Korea, and, increasingly, China exemplify how managing and controlling activities (i.e. innovation, research and development [R&D], and design) have enabled them to move towards higher-value stages of GVC activity. The increased competitiveness of an upstream economy has a large potential

to trickle down the gains along the value chain. A prerequisite for benefitting from such trickle down of spillovers is the capacity of firms to build adequate absorptive capacity, which includes developing local innovation and fostering human capital. Countries can also accrue benefits from downstream services closer to the final demand (i.e. logistics, marketing, and branding), although upstream economies generally tend to capture a larger share of the value added generated in GVCs than downstream economies.

Significant increases in FDI have been a major driver of economic growth and GVC activity due to the strong FDI–GVC link in ASEM

FDI can directly contribute to economic growth by enhancing a country's productivity through physical and human capital accumulation, as well as through technological and knowledge spillovers. Thriving in GVCs involves a crucial drive towards moving up the value chain – from labour-intensive, low value-added operations to higher value-added tasks involving technology transfer, productivity, and skills upgrading.

Propelled by MNCs and transnational corporations that continuously search for resource advantages, foreign investment can strengthen a country's integration in international trade. It can also enhance the efficiency of economic performance by directly or indirectly triggering a number of economic and social benefits. Such gains are magnified when the host economy reports a larger technological and knowledge gap – hence, possessing a greater catch-up potential in comparison with more technologically endowed countries.

As seen previously, large inflows of FDI have been a crucial driver of GVC participation in Europe and Asia, enhancing ASEM Partners' positioning in GVCs. As witnessed especially in East Asia and Southeast Asia, successful GVC engagement owes much to development strategies based on connecting FDI to GVCs, allowing countries to develop their industrial base and connect to global markets capitalising on their competitive advantage.

Decreased transport and telecommunication costs and business-friendly reforms in ASEM have ensured that countries can seize greater FDI opportunities to integrate in GVCs

Stable macroeconomic conditions, simplified customs procedures, and reduced trade barriers are instrumental in attracting FDI and optimally utilising GVCs. Evidence shows that countries dominating the high-value-added part of GVCs are those that rank high in competitiveness and ease-of-doing business indicators. Decreasing trade costs, quality institutions, good governance, and regulatory simplification are all traits of a business-friendly investment climate. To varying degrees, ASEM Partners have accomplished a competitive business climate and reputable investment record, and they have shown

resilience to FDI slowdown following the global financial crisis. According to the World Economic Forum Global Competitiveness Index, which measures the competitiveness performance of 137 countries in 12 domains, almost all ASEM Partners are featured in the first 50 positions, with the exception of South Asian and lower-income Southeast Asian countries reporting less competitive performances.

A streamlined investment regime and a conducive business environment significantly affect the decision of MNCs to establish investments overseas. The World Bank's Doing Business Report 2018 provides an interesting snapshot of which economies improved their business climate the most in 2017, supporting the claim that a good regulatory environment for domestic firms tends to be reflected also in a good one for foreign firms. The subregions with the highest share of reforming economies were Europe and Central Asia (79%) and South Asia (75%). The most common topics of reform in the two regions were the registration of property in Europe and Central Asia, and the protection of minority investors in South Asia. East Asia has also kept improving its ease of doing business, with its reform agenda dominated by tax and regulatory changes. In the first twenty positions of the ease of doing business ranking, New Zealand, Singapore, Korea, and Australia feature as the Asia-Pacific countries where it is easier to do business, respectively holding the 1st, 2nd, 4th, and 14th places.

Falling transportation and telecommunication costs have also contributed to building scale economies in Europe and Asia, leading countries to trade more with neighbouring economies. For instance, container freight rates from Shanghai to Singapore significantly decreased from US\$318 per 20-foot equivalent unit in 2010 to US\$70 in 2016 (UNCTAD, 2017b). The decline of freight costs, amongst other factors, helps to explain how it was possible to spread the production of manufactured goods from East Asia to Southeast Asia, allowing strong FDI-GVC linkages between the two subregions. However, the reduction of transportation costs has been uneven amongst ASEM subregions, partly explaining why Central Asia and South Asia were less able to attract FDI. For example, the average transport costs on the India-Bangladesh route were reportedly 40% higher than other highways in the East Asian region. Central Asia, too, faces the highest overland transportation and handling costs, which is reflected in its limited participation in GVCs (mainly as a supplier of natural resources) and significantly lower FDI inflows than other developing Asian countries.

Striving towards a predictable investment regime has allowed new EU members and increasingly Asia to seize greater FDI opportunities

Vital to its development policy, the Southeast Asia subregion has been particularly successful in attracting FDI. Most countries in the region have in fact welcomed foreign investment through a mix of incentives, targeted liberalisation, and strong investment protection guarantees. Over time, governments in Southeast Asia have continued to refine their investment legislation by opening more sectors to foreign investment and clarifying protection provisions. Accession to the WTO was also crucial in driving unilateral reforms to make the investment regime more attractive, as witnessed in the accession processes of the Lao PDR, Cambodia, and Viet Nam. For instance, in preparation for its accession to the WTO, Viet Nam substantially rewrote its commercial legislation and legal procedures in recent years. In particular, the legislative framework applicable to contracts, property rights, and the settlement of trade disputes have been considerably simplified and modernised.

Asian countries have also been early adopters of bilateral investment treaties (BITs) to provide additional protection to investors, with the progressive introduction of modern investment rules disciplining, inter alia, dispute settlement mechanisms and investments rights and obligations. According to ADB, Asian economies enforced 1,075 BITs globally during the period 2000–2016, which represents a significant proportion of BITs in force worldwide (of which there are more than 2,500)¹.

Spearheading investment activity, Europe has attracted massive FDI flows due to its stable and predictable investment regime as well as its advanced human and technological resources fuelling world-class European research, innovation, and competition. The EU has successfully managed one of the world's most open investment regimes, and, collectively, EU member states have the fewest restrictions in the world on FDI. To provide governance continuity and further certainty to its legal investment framework, the EU has ascribed to itself the exclusive competence of dealing with FDI, also becoming the only entity entitled to negotiate BITs with third countries (not its member states). The EU is currently engaged in designing a regional approach to investment screening and dispute resolution, which should set forth a common, predictable legal framework to promote its public policy interests while also guaranteeing a predictable dispute settlement mechanism for foreign investors.

¹ Retrieved from https://aric.adb.org/pdf/aeir/AEIR2016_special-theme-what-drives-fdi-in-asia-and-the-pacific.pdf.

In Europe and Asia (to a lesser extent), increasing regional integration has enabled neighbouring countries to trade intensively with each other, building competitive economies

The Asia–Pacific Regional Integration Index, an initiative of the Asian Development Bank that measures regional integration across six dimensions, suggests that Southeast Asia ranks highest, with an average score of 0.54 (on a scale from 0 to 1).² Performing well in all dimensions, in Southeast Asia, trade and investment integration and the free movement of people are particularly strong dimensions, ranking highest compared to other Asian regions. Unsurprisingly, the top four countries in the overall ranking are all in Southeast Asia: Singapore, Malaysia, Thailand, and Indonesia are the most regionally integrated economies amongst the surveyed Asian countries, followed by Korea and China. East Asia earns its highest scores for regional value chains and institutional and social integration, while it performs relatively weaker in regional trade and investment integration, perhaps because trade in final goods and FDI in East Asia are more global than regional. Kazakhstan, Pakistan, Bangladesh, and Mongolia report lower scores in the overall trade integration index, underperforming in infrastructure and connectivity, more specifically. Central Asia performs most poorly, with all averages for the dimensional indexes below the corresponding averages for Asia (Huh and Park, 2017). In comparison, the EU outperforms all other regions, with an average of 0.66, followed by Asia (0.41), Latin America (0.38), and Africa (0.35). The EU, which attains the highest scores on all dimensions, shows a particularly pronounced dominance in institutional and social integration (with its integration score in that area at least three times larger than that of other regions) and in money and finance integration. Only Asia’s trade and investment integration is nearly comparable in magnitude to that of the EU. The European and Asian success stories owe much to the vision of their leaders of fostering regional integration as a key driver of economic growth – although to varying degrees across the two regions. Pursuing common economic and/or political goals has been a distinctive feature of the ASEM policymaking agenda in past decades and has yielded large outcomes in terms of increased trade opportunities.

In Europe, deeper economic cooperation has led the way to an unparalleled breadth of regional integration over the last 60 years. With the exception of a few countries, European ASEM Partners have all joined the EU, creating a single, continentally vast market where goods, services, capital, and persons can move freely within its territory. The elimination

² The six dimensions measured by the Asia-Pacific Regional Integration Index are: (i) trade and investment integration, (ii) money and finance integration, (iii) regional value chains, (iv) infrastructure and connectivity, (v) the free movement of people, and (vi) institutional and social integration.

of internal tariffs and the creation of a customs union have been also accompanied by a removal of non-tariff barriers and a steadfast harmonisation of national regulatory environments into a newly streamlined regional one. This was possible due to a high degree of policymaking centralisation at the supranational level. Amongst its priorities, the EU is implementing a strategy to harmonise regulatory obstacles to harness the potential of a digital single market and is driving forward investment facilitation in strategic projects through the Investment Plan for Europe.

While South Asia and Central Asia have not yet experienced similar degrees of cooperation, Southeast Asia has accelerated its vision to drive regional integration

Although following a less ambitious path, Asia has also successfully embarked upon regional policy coordination efforts. The Asian integration success story holds interesting lessons for other developing countries and LDCs engaged in systemic efforts to spur their economic growth. By fostering regional integration through a ‘noodle bowl’ of FTAs, Asian ASEM Partners have been able to forge competitive regional value chains achieving economies of scale and the expansion of their market shares.

The ASEAN success story represents a good example of cooperation in the context of South–South regional integration, even without institutionalised decision-making powers. The establishment of the ASEAN Economic Community (AEC) in 2015 was an important milestone in the regional integration agenda in ASEAN, providing new impetus to achieve a competitive and cohesive community. The AEC Blueprint, adopted by ASEAN leaders in Kuala Lumpur in 2015, set forth an overarching vision to enhance connectivity and sectoral cooperation and to make ASEAN more dynamic, innovative, and inclusive. Given its heavy reliance on participation in GVCs and foreign investment, ASEAN is also continuously seeking to improve its business climate, undertaking regional responses to coordinate trade facilitation initiatives. The ASEAN Trade Facilitation Framework purposely aims to harmonise customs procedures and eliminate cumbersome NTMs, fostering a regional approach that combines the legitimacy of NTMs with the priority to reduce the time and cost of doing business in the region.

Trade facilitation has contributed to making the business environment more conducive to trade in ASEM, reducing the time and cost to import and export across borders. The implementation of trade facilitation measures varies greatly amongst subregions in Asia

In GVCs – where goods cross borders multiple times first as inputs and then as final products – time is of the essence to ensure the smooth functioning of supply chains. A country where inputs can be traded within a quick, predictable, and reliable timeframe is a more attractive

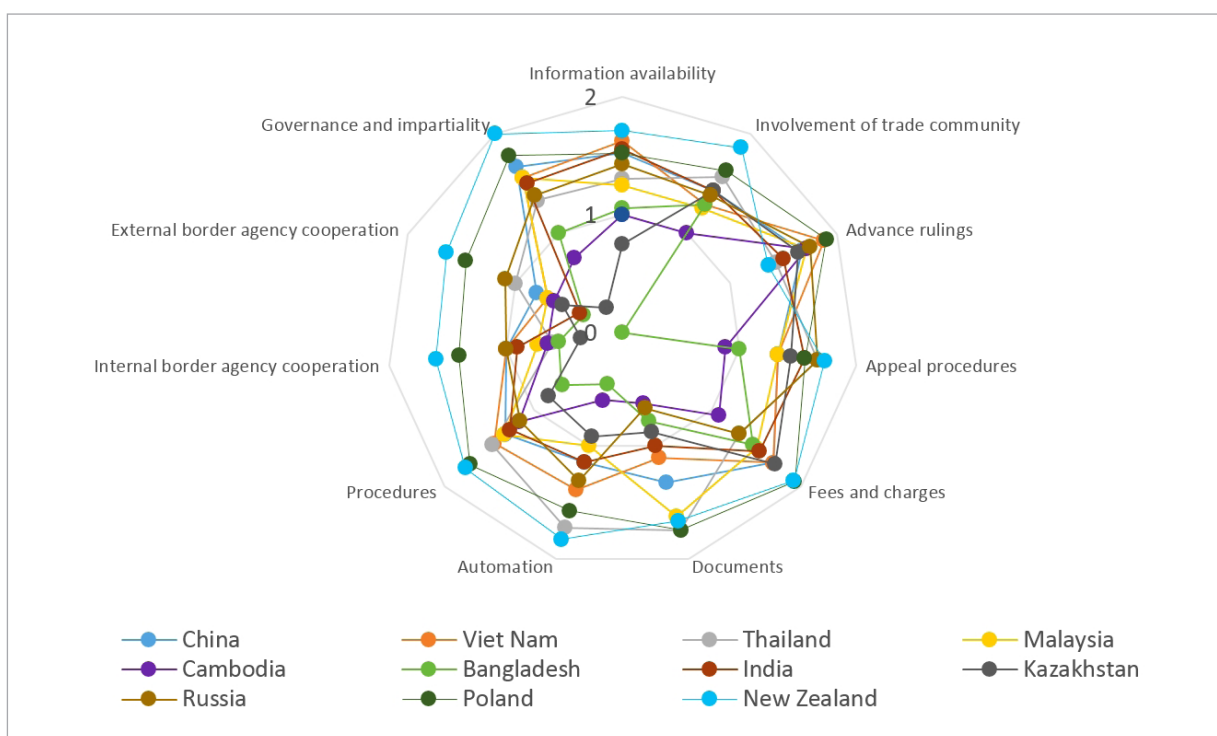
destination for foreign firms that plan to outsource part of their production process. Simple and efficient customs procedures are, thus, one of the key factors driving FDI decisions amongst foreign investors.

Europe and Asia lead efforts to facilitate cross-border trade, outperforming other regions in the world when counting the time and cost to import and export. With the exception of South Asia, where the time and cost to import in terms of border and documentary compliance is amongst the highest in the world, generally Europe and Asia report the least burdens captured by the number of dollars and hours spent to move goods across borders. Organisation for Economic Co-operation and Development (OECD) countries set a striking benchmark for cross-border trade operations, as it is estimated that it takes only 20 hours and US\$195 to fulfil documentary and border compliance to export goods from high-income OECD countries. Although their performance shows a non-negligible dip in comparison with OECD countries, countries from Southeast Asia, East Asia, and the Pacific report more competitive figures when compared to Latin America and Sub-Saharan Africa. For instance, it takes 126 hours and US\$562 to export from East Asia, compared to 154 hours and US\$629 for Latin America and 204 hours and US\$788 for Sub-Saharan Africa (World Bank Open Data).

Trade facilitation is defined as the simplification, modernisation, streamlining, and harmonisation of customs clearance procedures and documentation to reduce any unnecessary time and cost associated with import, export, and transit processes. Facilitating trade has been a key policy driver in many Asian countries to further reduce trade costs and smoothen the operation of business activities. Thanks to the implementation of trade facilitation measures in recent decades, Asian countries have achieved a number of efficiency gains, which are crucial for the timely movement of goods across several borders in GVCs. In Thailand, for instance, the implementation of the National Single Window in 2008 has allowed annual savings of US\$1.5 billion and reduced the time to export from 24 days in 2004 to 14 days in 2014. In the Philippines, electronic lodgement of documentation since 2007 has similarly made trade transactions for SMEs more efficient and less costly. In New Zealand, the implementation of a modern risk management system has quadruplicated the number of trade transactions from 1 million import entries in 2000 to 4 million in 2011, suggesting that trade facilitation is instrumental in increasing trade volumes.

The time and cost to fulfil border and documentary requirements provide an intuitive sense of the ease of trade in a country. However, transparency and efficiency at the border and behind the border – the key principles of trade facilitation – can be further broken down into a set of areas for action. Using the OECD trade facilitation indicators (Figure 6), we can evaluate how transparent and efficient customs procedures are in a given country.

Figure 6: : Trade Facilitation Performance of Selected ASEM Partners in 2017



Note: On a scale from 0 (low) to 2 (high).

Source: OECD Trade Facilitation Indicators, 2017.

With a few exceptions, generally ASEM Partners perform well in providing mechanisms to ensure fairness and non-discrimination, such as advance rulings to requesting traders concerning the classification, origin, and valuation method of a good at the time of importation. According to OECD estimations, ASEM Partners also report high scores in setting disciplines on fees and charges imposed on imports and exports as well as in granting traders the possibility to appeal administrative decisions issued by border agencies.

The United Nations (2017) Second Global Survey on the Implementation of Trade Facilitation and Paperless Trade Measures (2017), an initiative led by UNESCAP, shows improvements in the trade facilitation performance of countries in Asia and the Pacific.³ With respect to the first survey, carried out in 2015, Asia-Pacific countries have reportedly improved their implementation of general trade facilitation measures and paperless trade from 46.5% to 50.4% in 2017 – although results vary by subregion. Apart from Australia and New Zealand (80% implementation rate of trade facilitation measures), East Asia has the highest implementation rate at 73.7%, followed by Southeast Asia at 60.1%. Russia and Central Asia and South Asia reported, respectively, implementation rate of 51.8% and 46.5%, suggesting the need for further support in these subregions.

Subregional cooperation initiatives on trade facilitation in Asia have yielded positive results in the reduction of processing times and trade costs

Across subregions in Asia, joint initiatives in trade facilitation have encouraged collaboration amongst neighbouring governments to solve the problems common to their development challenges. In Central Asia, the Central Asia Regional Economic Cooperation (CAREC) Program was established to upgrade hard infrastructure and coordinate regional reforms for customs cooperation. As a result of hard and soft infrastructural improvements, the average clearance time at the border crossings of CAREC corridors and the average costs have declined, increasing intraregional trade volumes by 49% from 2005 to 2013 (ADB, 2017d).

In the Greater Mekong subregion, the Trade and Transport Facilitation Action Programme is supporting the expansion of infrastructure and the simplification and modernisation of customs procedures and border management. Under the programme, Thailand, Viet Nam, and the Lao PDR have upgraded the infrastructure along their corridor and streamlined single-stop customs inspection mechanisms at key border crossings, resulting in halved travel times (from 10 to 5 hours) and increased cross-border trade in the last two decades.

Countries participating in the South Asia Subregional Economic Cooperation (SASEC) forum have also pursued regional coordination to implement common trade facilitation initiatives. SASEC's Trade Facilitation Strategic Framework supports SASEC economies to address regulatory reforms and to streamline customs procedures, including the exchange of documents at major border crossing points and shifting towards process automation.

At the wider regional level, ASEAN has launched an ambitious plan to accelerate the implementation of trade facilitation measures, with a view to reducing trade transaction costs by 10% by 2020. At present, ASEAN has set the scene for a coordinated action to facilitate cross-border trade and reduce burdensome NTMs in the Trade Facilitation Strategic Action Plan 2017–2025. Implementation of the ASEAN Single Window has been also scaled up to simplify customs clearance and reduce release times in the region, with the filing of an increasing number of documents that can be exchanged amongst ASEAN Member States through the ASEAN Single Window.

In East Asia, China, Korea, and Japan are actively engaged in customs cooperation, supporting the establishment of a new mechanism for intelligence and data exchange. In comparison with other Asian regions, these countries in East Asia perform well in external border agency cooperation and are amongst the few countries with whom the EU has enhanced customs cooperation through the exchange of data and mutual recognition of Authorized Economic Operators.

Improvements in trade facilitation performance entail considerable economic gains and encourage more backward and forward linkages in GVCs. The entry into force of the WTO

Trade Facilitation Agreement (TFA) has provided new impetus for trade facilitation reforms. Especially in time-sensitive GVCs, transparent and efficient border procedures help firms curtail losses on perishable goods and decrease inventory management costs and additional costs related to uncertainty, unpredictability, and the discretionary behaviour of public officers at the border.

Trade facilitation is crucial for the ability of countries to benefit from increased backward (imported inputs used to produce exports) and forward linkages (exports of intermediaries processed in the importing country and then re-exported to a third country) in GVCs. For instance, an OECD (2018c) study estimated that even a modest increase in a country's trade facilitation performance of 0.1 units can spur increases in imports of value added ranging from 1.5% to 3.5%. The measures that appear to mostly encourage backward linkages in GVCs are advance rulings (3.5% increase in value-added trade), streamlined border procedures (3.3%), and predictability entailed by disciplines on fees and charges (3.2%). Likewise, on the supply side of the value chain, a small improvement in trade facilitation can produce increments in a country's exports of value added of between 1% and 2.5%. The trade facilitation measures that seem to have a wider impact on the efficiency of a country to export value added into GVCs are streamlined border procedures (3% increase), the automation of procedures (2.8%), and disciplines on fees and charges (2.5%).

Converging efforts of WTO Members to facilitate international trade and reduce unnecessary trade costs culminated in the entry into force of the WTO Trade Facilitation Agreement (TFA) on 22 February 2017. The TFA is a landmark multilateral agreement that aims to tackle the pressing procedural obstacles of cross-border trade, seeking to expedite the movement, release, and clearance of goods. Aimed at simplifying, streamlining, modernising and – to the extent possible – automating import, export, and transit procedures, the TFA is expected to generate trade cost reductions of up to 18% and increase world merchandise exports by US\$1 trillion per annum. The sizeable benefits of TFA implementation suggest that there is a strong case to keep momentum for trade facilitation reforms in the years to come. WTO members, which will fully implement the TFA, stand to reduce their trade costs by between 1.4 and 3.9 percentage points more than those who adopt a more minimalist approach. In particular, SMEs in low and lower-middle-income countries have the potential to enjoy the greatest opportunities for the largest reductions in trade costs and increased competitiveness, which will translate into greater participation by smaller firms in international trade.

The TFA has a unique architecture that connects the gradual implementation of the 36 measures of the agreement to the implementing capacities of developing countries and LDCs. For instance, by self-designating the implementation of measures into different categories (A, B, and C), developing and least-developed WTO members can defer the implementation of provisions (Category B) or make their implementation conditional upon the receipt of technical and financial assistance (Category C). Two-thirds of the Asia-Pacific members of the WTO have now ratified the TFA and are on their way towards its implementation. TFA implementation rates, however, vary greatly amongst different Asian subregions, with East Asia and Southeast Asia leading. South Asia and Central Asia, in contrast, appear amongst the lowest implementation rates.

Areas Demanding the Attention of ASEM Leaders: Barriers to GVC Integration

SMEs are at the bulk of economic activity in Asia and Europe and have many opportunities to thrive in the digital commerce era; however, in Asia they are not robustly integrated into GVCs

The fragmentation of international production has generated enormous opportunities for SMEs – especially those in developing countries and LDCs – to connect to global markets as components or services suppliers at reduced costs, without having to establish a product’s entire value chain. This is particularly advantageous for less productive or smaller firms, which can connect to international markets without the need to embrace all business functions in the value chain.

GVC success for SMEs hinges upon a combination of firm-level capabilities and conducive national policies for business. SMEs usually participate in GVCs by supplying MNCs that are located in their domestic market, or by operating trade and supply links with producers and buyers in other countries. Participation in GVCs can be considerably profitable for exporting SMEs as it has the potential to reduce the costs of internationalisation while making them more flexible and efficient through technological transfer, skills upgrading, and innovation. Moreover, new market niches for the supply of new products and services steadily emerge, enabling SMEs to specialise in specific functions and/or products at lower costs.

Worldwide SMEs constitute on average 95% of all firms. They absorb more than half of total exports in value-added terms and generate half of the employment in emerging economies (up to 70% in most developed countries). In Europe, SMEs are the lifeblood of economic growth, representing 99.8% of all businesses, accounting for more than two-thirds of

employment, and generating 58% of GDP. Likewise, SMEs are the largest generators of jobs in developing Asia. Evidence shows that SMEs in East Asia, Southeast Asia, and South Asia account on average for 98% of all enterprises, although their share of employment varies significantly from 25% to 80% in the different countries. Similarly, their share of contribution to GDP ranges from 25% to 60%, although most countries fall into a range of 30% to 50%.

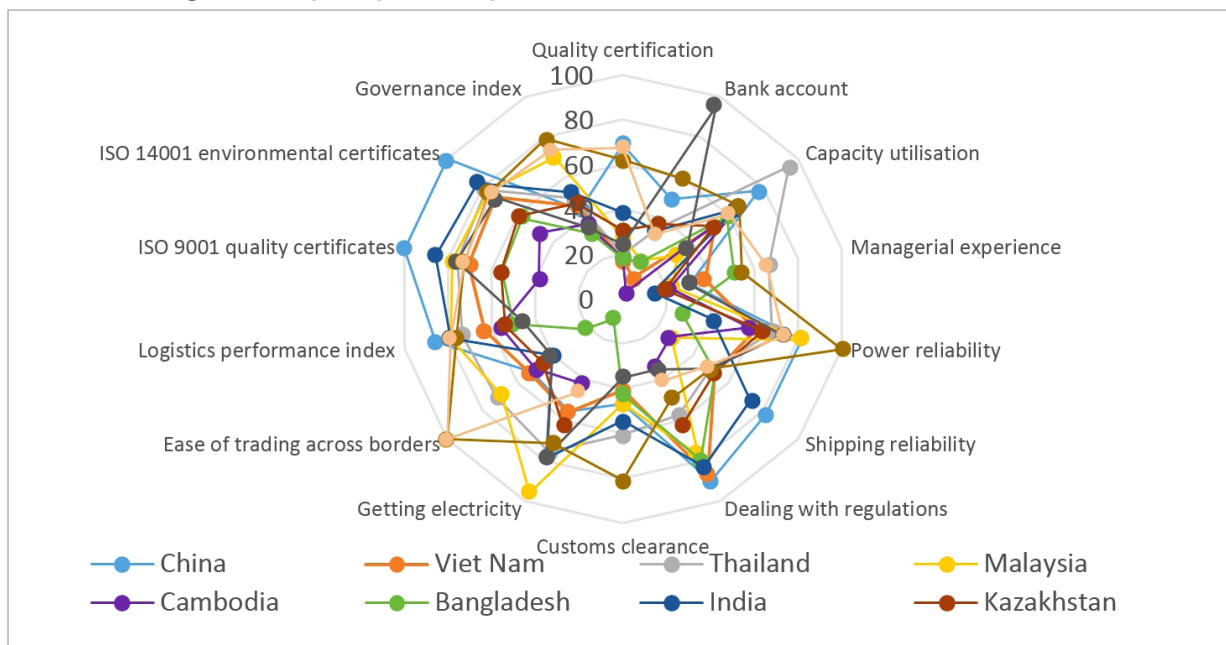
Notwithstanding their presence in their national economies, SMEs appear to be underrepresented in GVC trade. Data on the contribution of SMEs to GVCs directly as exporters, or indirectly as suppliers or subcontractors to large firms, are scarce. For instance, an ADB Institute study suggests that only 22% of all SMEs in ASEAN economies participate in GVC trade, compared with 72.1% of all large enterprises.⁴ Such firms are typically hampered from integrating into regional and GVCs due to a lack of access to finance from commercial banks, gaps in managerial and technological capabilities, and cumbersome bureaucratic regulations relating to business operations.

In the different Asian subregions, smaller firms face higher costs due to their inability to capitalise on economies of scale. They also show higher gaps in competing and connecting to GVCs due to a lack of managerial capabilities and the inability to internalise technology. Fragmentation of production and the massive development of ICT have leveraged new entrepreneurial possibilities for SMEs, with ICT solutions easing access to markets beyond national borders. However, this potential remains largely untapped as most SMEs face serious connectivity challenges for participating in GVCs due to a number of factors, including a lack of financial and managerial resources, lack of economies of scale, higher transaction costs, and the inability to internalise technology and knowledge. Moreover, the ability of small firms to upgrade in a value chain entails undertaking a more complex set of tasks, which typically has repercussions on their business competitiveness. Strengthening the cost-effective engagement of SMEs in GVCs therefore remains an important policy challenge for ASEM leaders in the years to come.

⁴ Retrieved from <https://www.asiapathways-adbi.org/2012/07/asias-growth-production-networks-and-smes/>

Using the International Trade Centre (ITC) SME Competitiveness Outlook methodology, we can observe that generally, small firms across Asia have a lower capacity to connect, change, and compete internationally compared to larger firms – with the sole exception of China, whose small enterprises generally perform well in almost all indicators.⁵ In the surveyed countries in Southeast Asia, South Asia, and Central Asia, for instance, the most common issues hampering the capacity to compete of small firms were the low usage of bank accounts, the low ownership of quality certificates, and poor managerial experience at the firm capabilities level (Figure 7).

Figure 7: Capacity to Compete of Small Firms in Selected ASEM Partners



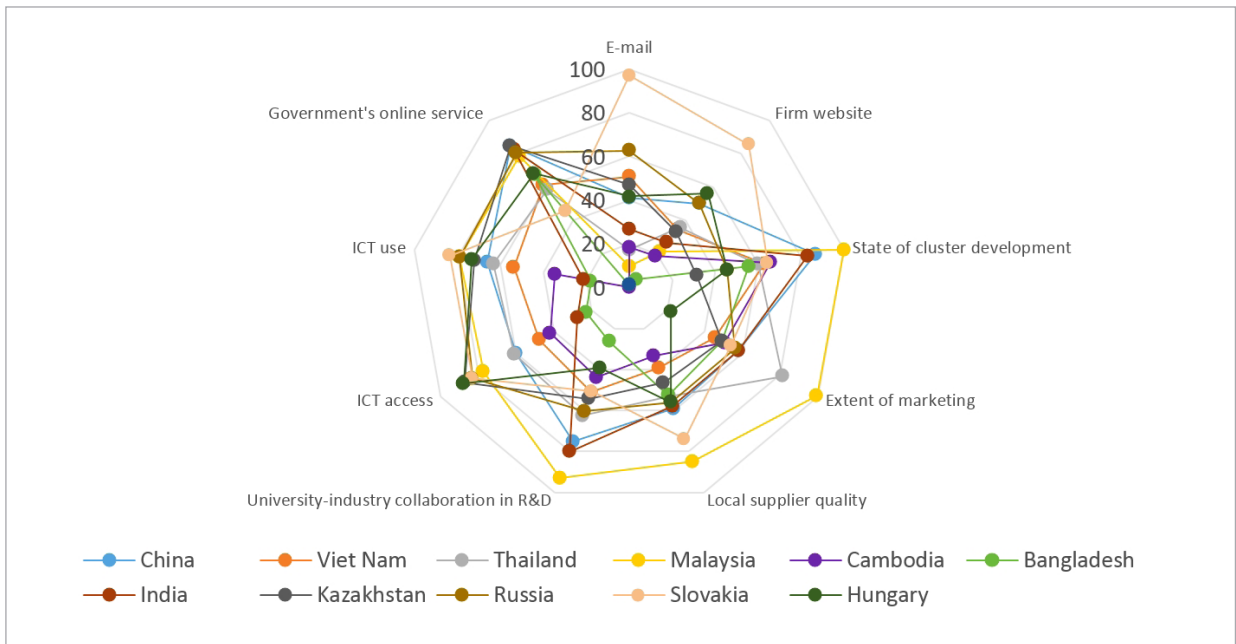
Source: ITC (2017a).

The capacity to connect was problematic for the surveyed Asian countries, as they all generally reported the scarce use of e-mails and firm websites at the firm capabilities level (except for Viet Nam, Kazakhstan, India, and Russia) (Figure 8).

Finally, small firms in the different subregions in Asia show weaknesses also in their capacity to change, mainly underperforming at the firm capabilities level in having audited financial statements and formal training programmes, and in owning foreign technology licenses. In lower-income economies, such as Cambodia and Bangladesh, the lower capacity to change is also negatively reported in the low number of trademark registrations at the national environment level (Figure 9).

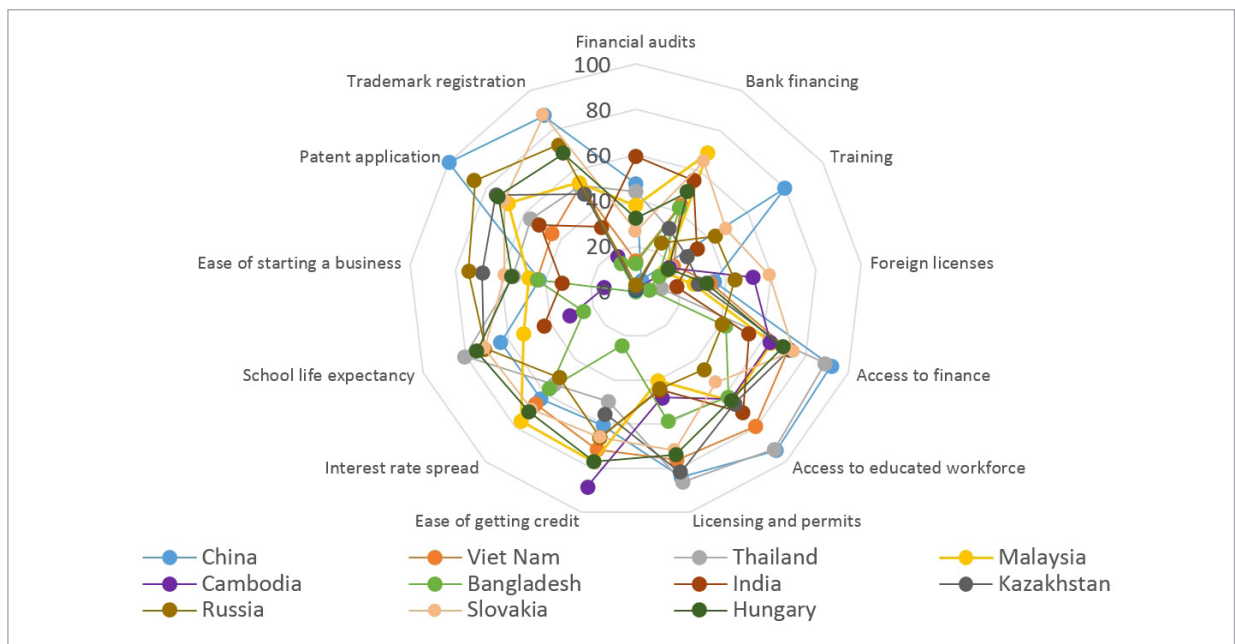
⁵The ITC SME Competitiveness Outlook measures SME competitiveness in selected countries on the basis of specific criteria that address firm capabilities, the business ecosystem, and the national environment on a scale from 0 to 100.

Figure 8: Capacity to Connect of Small Firms in Selected ASEM Partners



ICT = information and communication technology, R&D = research and development.
Source: ITC (2017a).

Figure 9: Capacity to Change of Small Firms in Selected ASEM Partners



Source: ITC (2017a).

Although tariffs in Europe and Asia have decreased, other behind-the-border barriers have progressively continued to pose even higher costs on SMEs

While sizeable trade liberalisation has significantly lowered traditional tariffs in Europe and Asia, trade costs associated with NTMs and other costs are continually on the rise. NTMs encompass a wide array of measures applied to tradable goods and are in principle employed to pursue legitimate public policy objectives, such as the protection of human, animal, and plant life or health. Specifically, non-discriminatory standards are regulated by qualitative NTMs, such as SPS and TBT, to assure certain quality standards and characteristics of imported products. Other than qualitative ones, trade partners usually impose quantitative NTMs, such as antidumping duties, safeguards, and countervailing measures against restrictive or discriminatory policy measures. Regardless of their nature, NTMs often represent a disguised restriction to trade, even if unintentionally. Such regulations, for instance, can affect trade flows in various ways and the price of products at different stages of the production chain, raising the overall trade costs borne by producers. For instance, it is estimated that nowadays NTMs add on average 87% to the restrictiveness imposed by tariffs (APEC, 2014).

The opaque proliferation of NTMs notified to the WTO provides interesting data on the magnitude of behind-the-border barriers. As of December 2017, there were around 6,300 NTMs amongst SPS and TBT, 1,716 antidumping measures, and 1,635 quantitative restriction actions in force, representing the top four categories of most notified NTMs globally. The restrictive nature of NTMs is especially burdensome for exporters from LDCs, who reportedly lose an estimated US\$23 billion a year – that is, 15% of their exports, which far exceeds the loss incurred by remaining tariffs – because they are unable to comply with NTMs.⁶

NTMs have become increasingly important within GVCs to promote access to information and the traceability of products; however, they make compliance for small-scale businesses extremely difficult and impede their integration in GVCs

Access to information and the traceability of products have become increasingly important within GVCs, leading policymakers worldwide to exponentially raise the number of quality and safety standards. While the need to protect consumers and correct market failures using the policy arm of NTMs should not be underestimated, their complexity – and above all their heterogeneity – has become one of the main barriers to the participation of firms in GVCs. For instance, upstream firms supplying a given part or component to several destinations may face the need to modify their production process to comply with different standards; or

they may incur burdensome certification procedures several times for the same product to comply with different rules of origin requirements.

SMEs are likely to be more negatively affected by NTMs than larger firms as they typically bear higher costs due to their smaller scale. This is mainly due to the overly complex nature of multiple requirements, which makes compliance more puzzling for small-scale enterprises with limited resources and no economy of scale upon which to capitalise. An ITC (2016) study found that a 10% increase in burdensome regulations is associated with a 3.2% decrease in the export value of small firms, whereas for large firms, the decrease in the export value only amounts to 1.6%.

ADB suggests that NTMs have become a major obstacle to trade since the global financial crisis, with generally negative effects on developing Asia's trade. It is estimated that the number of NTMs imposed on developing Asia by non-Asian countries more than tripled from 2,263 in 2000 to 7,190 in 2015, dominated by SPS measures (28.5%), TBT measures (23.4%), and tariff quotas (15.5%). Although the figure of NTMs imposed by developing Asia against non-Asian partners is much lower – 2,217 measures in 2015 – they too quadrupled since 2000, when imposed NTMs were only 534. While SPS measures (26.6%) were also prominent amongst NTMs applied by developing Asia in 2015, other measures, such as quantitative restrictions (24.5%) and antidumping measures (21.4%), captured considerable shares of total NTMs imposed by Asia.

Procedural obstacles encountered for complying with NTMs are a major hurdle for SMEs in Asia, which often lack the resources to minimise the impact of trade costs arising from such obstacles

NTMs in the form of burdensome administrative procedures, rather than just stringent standards and regulations, pose a major hurdle for firms in their daily operations. According to a series of business surveys on NTMs undertaken by the ITC, surveyed firms in different countries revealed that more than three-quarters of reported NTMs are to be attributed to procedural obstacles linked to the NTM, rather than to the strictness of the regulation itself. This means that traders perceive the procedures for complying with the regulation more stringent than the regulatory requirements. For instance, complex and lengthy customs procedures, delays to obtain permits and fulfil paperwork, high fees and charges, redundant documentation, and arbitrary behaviour by officials are all procedural obstacles that firms are likely to encounter in the process of complying with import or export regulations. Procedural obstacles are a heavy burden, especially for SMEs, which often lack the appropriate resources to tackle these obstacles.

In Cambodia, small and medium businesses surveyed by the ITC revealed that 96% of the reported NTM cases were difficult for the exporters due to related procedural obstacles, with time delays (52%) and informal payments (22%) as the most burdensome hurdles. Similarly, in Indonesia, respondents reported that 88% of the NTMs affecting Indonesian exports were considered burdensome due to associated procedural obstacles as they contended that administrative red tape and delays (52%) and unusually high fees and charges for certification (26%) in the application process were the main sources of burden rather than the measures themselves. Importers also reported that the arbitrary behaviour of officials regarding the classification and valuation of goods at customs was a major procedural burden (25%). Also, Kazakhstan shows an analogous picture, whereby the surveyed companies reported that procedural obstacles (81%) were more burdensome than the regulations themselves, with the large number of documents, unusually high fees and charges, and the arbitrary behaviour of officials as the top three barriers faced by imports and exporters alike. In Central Asia, the high presence of NTMs, coupled with inefficient customs procedures and high transportation costs, explains why the share of intraregional trade relative to the region's overall trade does not exceed 20%, with NTMs that can account for up to 30% of the total export value in some countries (Vinokurov, 2017).

Asian subregions reveal gaps in the implementation of trade facilitation reforms and their negative impact on connectivity. Countries report the biggest gaps in institutional arrangements for border cooperation, simplified documentation, and the automation of procedures

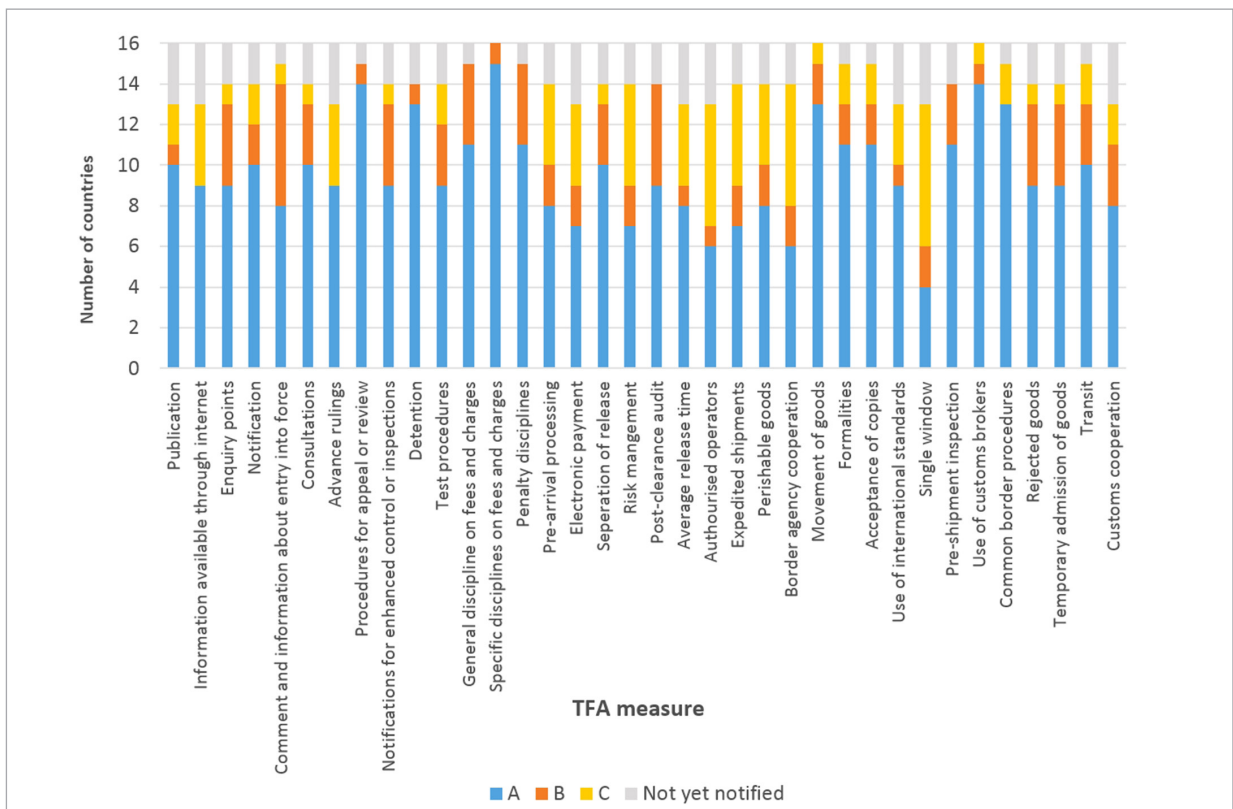
As mentioned previously, subregions in Asia have varying degrees of development and are at different stages of implementation of trade facilitation measures based on their national resources and institutional capacity. East Asia spearheads the implementation of trade facilitation measures, whereas South Asia and Central Asia close the rank. For example, implementation levels of paperless trade measures in South Asia and Central Asia are well below those of East Asia and Southeast Asia. However, as seen in Figure 6, the implementation of trade facilitation reforms also varies within the same subregion. For instance, in Southeast Asia, Malaysia and Thailand perform better in a number of trade facilitation areas than lower-income economies such as Cambodia, the Lao PDR, and Myanmar.

An analysis of the ratifications and notifications of the WTO TFA by Asian ASEM Partners confirms the critical areas in the implementation of trade facilitation reforms and the negative impact of these gaps on connectivity (see Figure 10). Most Asian members of the have ratified the agreement and notified the status of categorisation of each measure.

Figure 10 shows the measures that have been most notified in Category C in Asia. Trade facilitation measures for authorised operators (Article 7.7), border agency cooperation (Article 8), and the single window (Article 10.4) are the three measures that Asian ASEM Partners have notified the most in Category C, meaning that these countries will need additional time, capacity-building support, and/or financial assistance to implement the measures. Significantly, these WTO articles are large-scope measures that have a direct impact on ASEM Partners’ connectivity and integration with regional and global value chains, particularly for landlocked countries. Hence, they require a concerted approach to policy reform due to their complexity.

Further connectivity is especially affected by the lack of institutional and legal framework to support cross-border paperless trade. Attempts to engage in the cross-border exchange of electronic data have been very limited in Asian subregions and have not allowed for a full legal recognition of electronic data or documentation submitted from stakeholders in other countries. For example, the electronic exchange of certificates of origin and SPS certificates has been implemented marginally by less than 20% of countries in Asia and the Pacific. This suggests that regional cooperation has to be strengthened to overcome the technical and legal challenges that hinder the cross-border exchange of electronic information.

Figure 10: Categorisation of TFA Measures by Least-developed and Developing ASEM Members



TFA = Trade Facilitation Agreement.

Note: The countries include ASEAN Member States, China, India, Pakistan, Bangladesh, Mongolia, and Kazakhstan.

Source: WTO Trade Facilitation Agreement Facility.

Despite improvements in the last decade, services restrictiveness still affects the competitiveness of Asian economies. Services restrictiveness is particularly detrimental for countries connected to GVCs and prevents them from upgrading in the chain

Trade in services is affected by domestic regulations that can restrict their supply. This often results in barriers to trade and connectivity, which can take the form of horizontal regulations that affect all services sectors or sector-specific regulations. Restrictiveness in the services sector is the result of an inadequate pro-competitive regulatory environment and restrictions to FDI in services at the domestic level. Inefficient services generate productivity and skills gaps, missed business opportunities, lack of creation of new jobs, and slower economic growth.

Although some progress has been achieved over the last decade in terms of regulatory reforms and the increased contribution of services to GDP, a broad set of restrictions still remains. Services still underperform in trade relative to their contribution to GDP in nearly all the developing Asian economies. Despite massive FDI inflows, Southeast Asia is still particularly restrictive in services, acting as a hindrance to inclusive growth and productivity. It is reported that ASEAN countries' average level of restrictiveness is 60% higher than the global average. With the exception of Singapore and the Philippines, services contribute around 50% to GDP in ASEAN countries, which corresponds to the average contribution of services in low-income rather than middle-income economies (OECD, 2018d). Moreover, six Southeast Asian economies appear amongst the 10 most restrictive countries in a sample of 60 countries when it comes to foreign investment in the services sector, as measured by the OECD's FDI Regulatory Restrictiveness Index.

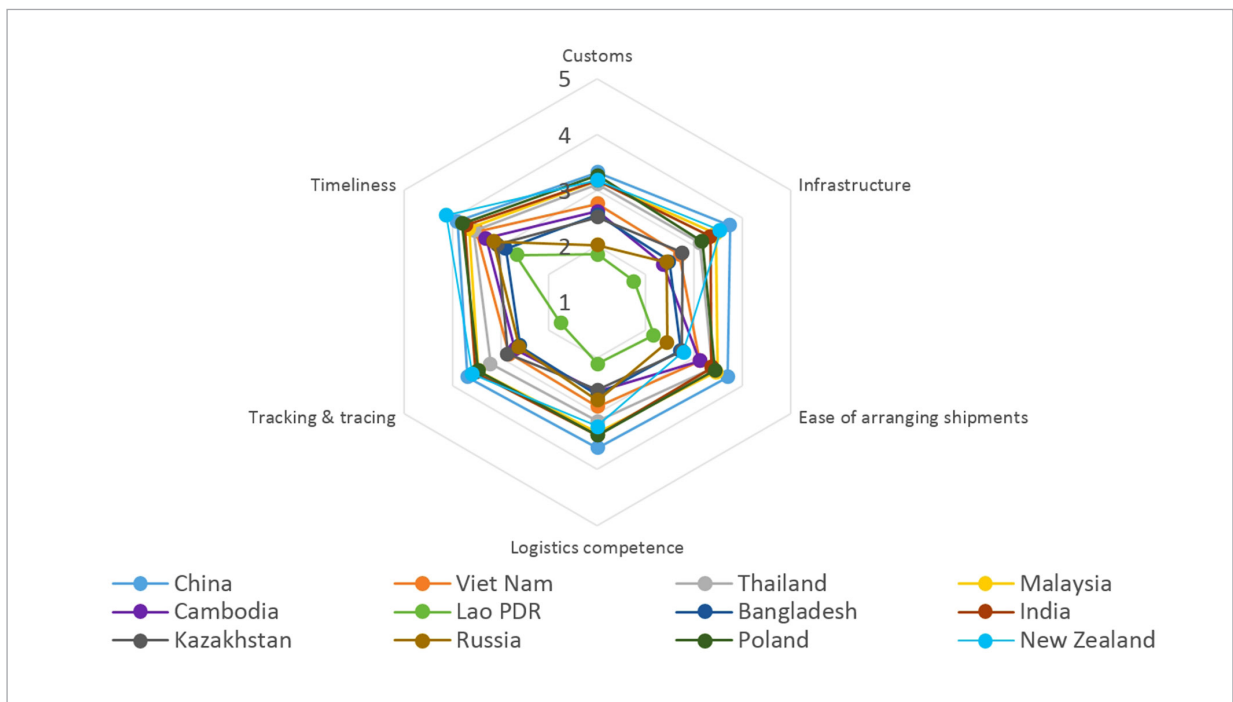
The OECD's Service Trade Restrictiveness Index (STRI) shows that services sectors, in particular those crucial to connectivity and integration, are generally more restrictive in non-OECD Asian countries (including Russia) than they are in OECD European or Asian countries.⁷ High-income ASEM Partners in Asia and Europe have generally adopted more liberalised services trade policies. In contrast, upper-middle-income and lower-middle-income Asia shows higher restrictions in almost all services sectors – with the sole exception of Russia, which reports high restrictiveness scores in many services sectors notwithstanding its ranking amongst high-income economies.

⁷The STRI provides an analysis of services trade barriers in 22 sectors across 44 countries using a 0 (open) to 1 (closed) methodology to determine the position of countries in the index.

⁸The only non-OECD Asian countries that the OECD STRI measures are China, India, Indonesia, and Russia.

China, India, Indonesia, and Russia all report above-average restrictions in key sectors that are crucial to the smooth functioning of GVCs, such as logistics, transport, distribution, and ICT.⁸ In the logistics sector and related subsectors, such as cargo handling and warehousing, these four countries (with Russia ahead) report amongst the highest STRI scores, mainly in the form of restrictions to foreign entry, barriers to competition, and low regulatory transparency. In Russia, in particular, these services are restricted to a statutory monopoly at all facilities, prohibiting any foreign operation. In China, courier services are restricted and foreign investment is prohibited, although the government has started to grant licenses to foreign companies to operate express delivery services in a few regions. In global production networks and just-in-time delivery, fast and reliable logistics services are particularly important to the smooth functioning of supply chains. The World Bank Logistics Performance Index (LPI) reveals how countries in South Asia and Central Asia and lower-middle income countries in Southeast Asia report lower scores in terms of the quality and competence of the logistics services offered in comparison to European economies (Figure 11).⁹

Figure 11: Logistics Performance of Selected ASEM Partners in 2016



Note: On a scale from 1 (very low) to 5 (very high).

Source: World Bank Logistics Performance Index, 2016.

⁹The LPI measures the logistics performance of 160 economies on a scale from 1 (very low) to 5 (very high) on the basis of six criteria: (i) customs efficiency, (ii) quality of infrastructure, (iii) ease of arranging competitively priced shipments, (iv) competence and quality of logistics services, (v) ability to track and trace consignments, and (vi) timeliness of shipments.

An International Trade Centre (2017c) study assessed how the fragmented regulations of logistics services, skewed competition, and entry and operational restrictions can significantly hamper the opportunity of logistics services providers to supply integrated quality services in a cost-effective manner to their clients. Transport and logistics services therefore call for a reduction of unnecessary restrictions to improve the productivity in downstream industries in GVCs as well as in the subsectors themselves. It is estimated that each day saved in shipping time is worth 1% of the product value for manufactured goods, thus signalling that the speed and cost of logistics services are particularly crucial for those goods relying on just-in-time delivery.

In telecommunications, China, India, Indonesia, and Russia report the highest restriction scores, determined by restrictions to foreign entry and barriers to competition, although Indonesia and China are starting to implement some reforms in the sector (including efforts to allow higher foreign equity participation). Pro-competition telecommunications services are also vital to GVCs as they contribute to lowering the cost of coordinating complex tasks within and between firms over long distances.

In contrast, OECD European and Asian countries report scores of services restrictiveness below the average in almost all sectors, meaning that they maintain low restrictions to services across sectors. One exception in most European countries – and in line with the pattern of non-OECD countries – is represented by high restrictions in professional services, such as architectural, engineering, legal, and accounting services. This reflects the traditional tendency for professional services to be subject to a high level of regulation by national governments, supported by professional bodies, to limit foreign operations based on nationality requirements, limitations on the business forms accepted, and a lack of recognition of foreign qualifications.

Different levels of competitiveness and technological advancement occur amongst ASEM economies, determining their different positioning in GVCs. The inability to exploit services to move upwards in GVCs and absorb technological and knowledge spillovers widens the gap amongst better-performing and lagging economies in ASEM

While openness to FDI has been identified as a key factor that can boost economic growth, its untapped potential for upgrading in GVCs can entail structural challenges for countries based on their different development and income levels.

The capacity to absorb FDI is as important – if not more important – as the capacity to

attract foreign investment for the national development of a country. Despite its large spillover potential, not all investments manage to generate positive outcomes in the domestic market of the FDI-recipient country due to, inter alia, a lack of endogenous absorptive capacity. The availability of local assets, such as the maturity of the financial system, educated human capital, and the ability to exploit external knowledge, heavily affects the positive impact of FDI on the economic growth of a host country.

Even in the presence of foreign investment, the inability of lower-middle-income Asian countries to shift away from simple, low-skill manufacturing tasks under foreign guidance and upgrade their low value-added industrial complexity can jeopardise their transition towards higher levels of income and growth. Positive spillovers in terms of skills, technology, and know-how transfer that can be generated from foreign investment do not find a fertile, absorptive ground in the local industries. As a result, domestic firms in lower-middle-income countries are unable to follow an upwards trajectory in the value chain and are unable to achieve skills and process upgrading due to a lack of adequate transmission channels from GVC participation to the domestic economy.

Upper-middle-income Asian countries face a similar problem as they seek to move towards more sophisticated, high value-added GVCs that entail a greater degree of industrial complexity and technology. Many argue that countries such as Thailand, Malaysia, and China are all facing the likelihood of failing the transition towards high-income levels, and stagnating between the low-wage, low-income competitor countries that dominate labour-intensive industries and the high-income country innovators that dominate industries undergoing rapid technological change. Middle-income countries – which have advanced manufacturing industries but are still under foreign guidance – face the possibility of being unable to break the glass ceiling of technological innovation if they do not master adequately the management skills and technology required to produce or even design high-quality goods. In other words, they lack the necessary economic complexity and institutional sophistication needed to absorb and master the technology capacity to shift to high value-added production, which usually entails product or functional upgrading, or move towards high value-added services (i.e. R&D and branding).

Policy Recommendations to Further Enhance Asia–Europe Institutional Connectivity in ASEM

Connectivity through GVC integration will continue to dominate the landscape of inter-regional dialogue in Europe and Asia. Although sustained openness to trade and investment will continue to be the backbone of successful regional integration, ASEM policymakers should further pursue trade and investment facilitation policies to cope with the modern challenges of international trade.

In particular, ASEM leaders and trade policymakers need to take account of the different business realities in GVCs and rethink a complementary policy agenda that can adapt to the different stages of development of ASEM economies. The key initiatives in this regard include addressing NTMs in trade in goods, further liberalising trade in services, strengthening sound investment policies, and implementing trade facilitation reforms. The following recommendations could support the current work that ASEM is advancing in strengthening connectivity between the two regions.

Keep pursuing deep and comprehensive FTAs with services, investment, and trade facilitation provisions as a means to spur an enabling climate for further trade liberalisation. Regional approaches for negotiating FTAs should be sought to simplify rules and pursue deeper cooperation in a number of domains

To achieve further trade liberalisation, Europe and Asia should continue to pursue their FTA negotiation agendas at a fast pace. These new agreements should comprehensively discipline not only trade in goods but also services and investment provisions. Greater efforts to liberalise trade in services are crucial to reduce the cost of services linkages between production blocks and increase GVC trade between countries. Likewise, FTAs with investment provisions have a stronger effect on value chain integration than standalone BITs (ITC, 2017a). Dealing with trade and investment under a single legal umbrella, instead of signing BITs, has a greater effect on the level of domestic value-added in exports through GVCs. These deep and comprehensive FTAs might also include ‘TFA-plus’ provisions so that trade partners in an FTA can deepen their commitments to simplifying customs procedures. Regional trade deals should be prioritised to streamline overlapping regulatory requirements, align regulations and standards, and deepen regional integration. However, as not all countries share the same level of development in Asia, all-encompassing bilateral FTAs can still serve the purpose of liberalising trade, services, and investment while allowing for greater flexibility towards lesser-developed ASEM economies.

At present, a regional approach could be encouraged to accelerate the negotiation of the Regional Comprehensive Economic Partnership (RCEP) consisting of ASEAN+6. This trade deal would potentially turn Asia into one of the largest world trade areas. With the Trans-Pacific Partnership (TPP) at an impasse, and with tariffs already low in the region, RCEP currently represents an enormous opportunity for Asian economies to foster their connectivity beyond the elimination of tariffs. While arguably not as comprehensive and deep as the TPP, RCEP can bring notable benefits to its members as the trade deal is likely to reduce import tariffs and make rules of origin more consistent across members, thereby facilitating GVC trade. This type of agreement is in fact seeking to advance a common regional approach to improve transparency of NTMs and achieve mutual recognition (rather than harmonisation) while also bridging the gaps in investment cooperation (Cadot and Ing, 2015).

Use ASEM as a forum to enhance the connectivity of SMEs in the digital marketplace and advance talks on e-commerce-related topics, such as user confidence and security protection

Enhancing the role and participation of small businesses in the global marketplace through e-commerce will be of critical importance in the years to come. It is estimated that around 97% of Internet-enabled small businesses export, while export participation rates for traditional SMEs range between 2% and 28% in most countries. This means that digital commerce provides an enormous opportunity for SMEs to break barriers and participate in international trade.

Fostering access to technology and a more robust uptake of e-commerce will be especially crucial for SMEs to connect, compete, and grow in global markets. Digital commerce has the potential to bridge the traditional gaps faced by SMEs in competing with larger firms, improving the flow of information and ideas across boundaries as well as fostering links with an increasing number of buyers and sellers. ASEM leaders and policymakers can play a key role in supporting the integration of SMEs in GVCs by encouraging the development of linkages with international firms, fostering their supply capacity and ability to innovate. ASEM can serve as the ideal forum where national policymakers can advance talks on themes such as user confidence and security protection, and discuss policies to facilitate the engagement of SMEs in digital trade, including schemes for ICT training and skills development.

Establish robust cooperation for addressing NTMs for increased economic growth and set up an ASEM committee for the surveillance of NTMs in Asia and Europe

In light of the obstacles that NTMs pose to the competitiveness of firms – especially those firms heavily embedded in GVCs – ASEM as a forum should foster dialogue and coordination aimed at streamlining NTMs across the two regions. When regulatory divergences are not too high, the negotiation of mutual recognition agreements (MRAs) represents a feasible and less costly solution to explore. In contrast, when the regulatory divergence between two or more partners is substantive, changes or reforms in the domestic regulation in efforts of harmonisation are more likely to occur (Correia de Brito et al., 2016). Therefore, ASEM plays a key role in facilitating the dialogue amongst ASEM Partners with efforts for advancing cooperation on the elimination of burdensome NTMs – fostering the underlying principle that when economies choose to negotiate MRAs or harmonise regulatory provisions, they should do so in conformity with their respective degrees of national development.

To minimise the impact that NTMs place on trade connectivity between Asia and Europe, ASEM should institutionalise a committee mandated to monitor and report the introduction of new NTMs and any improvements in the removal of NTMs. This committee would share early-warning messages with the countries that are affected or going to be affected by the introduction of a new NTM, with a view to facilitating traders' compliance. The committee would also be responsible for proposing recommendations to tackle specific regulatory stringencies as well as procedural obstacles in ASEM countries that are unnecessary for fulfilling customs clearance.

Coordinate a regional implementation of trade facilitation reforms in ASEM to promote mutually workable solutions and reduce common procedural obstacles to trade

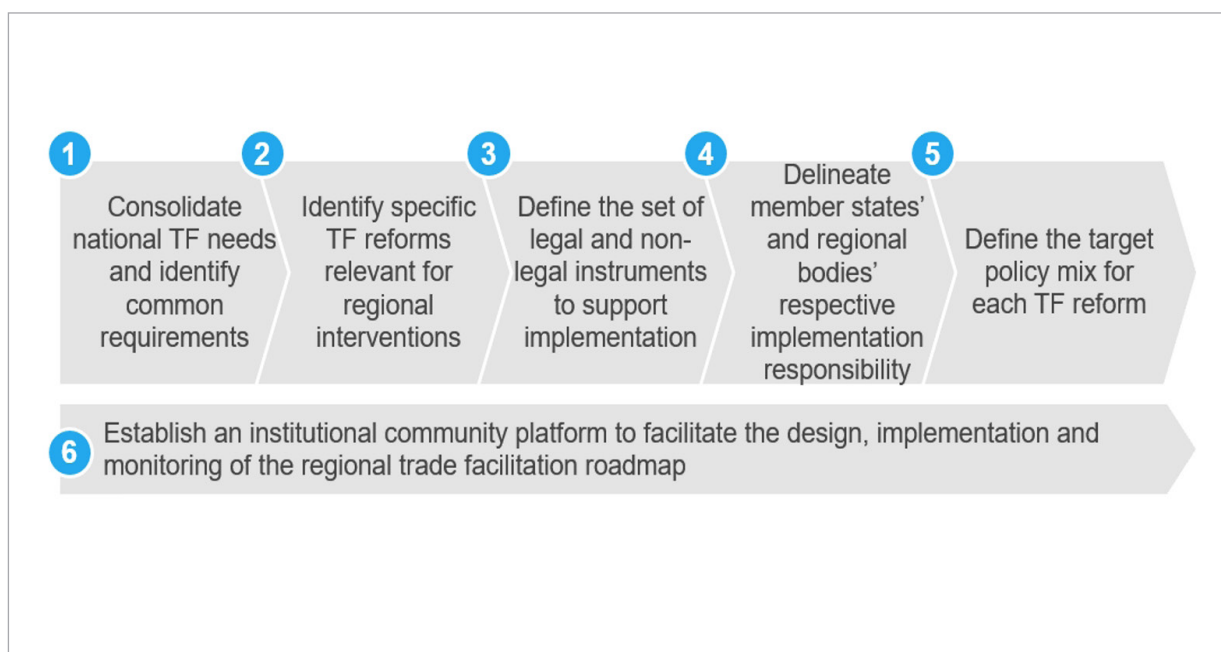
Trade facilitation plays a key role in enhancing Europe–Asia physical and institutional connectivity. As a platform, ASEM can promote regionally coordinated approaches for the design and operationalisation of trade facilitation reforms in prioritised areas where technical and capacity-building support is mostly needed. This will help lesser-developed countries to learn from the experiences of their regional partners and maximise the potential benefits of regional integration through trade facilitation reforms.

Regional approaches for implementing trade facilitation measures can deliver greater benefits to individual countries and the regional community than just unconnected national reforms. Coordinated cross-border reforms would help create a more consistent and predictable regional trading environment by avoiding the imposition of diverging administrative procedures and requirements in countries that are part of regional economic communities. Harmonised formalities across regions would reduce business transaction

costs, create the necessary conditions for the development of regional value chains, and be an important investment tool.

The regional dimension of trade facilitation reforms should, thus, be pursued if Asia and Europe stand to gain the maximum benefits from a conducive cross-border trading environment. ASEM could serve as a privileged forum where countries (either individually, sub-regionally, or as the regional economic community they belong to) can pioneer regionally designed policies. ITC (2017b) has developed a six-step methodology to boost regionally coordinated policies for TFA implementation that aims at identifying specific trade facilitation reforms relevant for regional interventions, designed, implemented, and monitored through an institutionalised community platform (Figure 12). ASEM could capitalise on such a regional approach to remove common stringent bottlenecks to cross-border trade using a set of non-legal instruments to find consensus on those trade facilitation reforms that are likely to yield the largest mutual benefits.

Figure 12: Six-step Methodology to Coordinate Regional Trade Facilitation Reforms



TF = trade facilitation.

Source: ITC (2017b).

As a priority, ASEM Partners engaged in trade facilitation reforms should strengthen their dialogue and coordination efforts in the ASEM forum to improve coordinated border management and paperless trade initiatives, identify international best practices, and converge on common approaches to improve their performance.

Additionally, ASEM could intensify the dialogue to strengthen cooperation between border agencies. At a more ambitious stage, ASEM Partners could also agree to move beyond minimum TFA obligations, committing to implement voluntary TFA-plus standards, which would magnify the beneficial impact of TFA measures. For example, ASEM Partners could recognise and coordinate mutual efforts to promote the use of automation and electronic means, even for those provisions where the TFA does not necessarily require members to adopt technology-driven solutions to comply with the given measures.

Differentiate investment policies based on the country's level of development. Implement policies geared towards not only investment facilitation but also investment absorption to develop or enhance indigenous technological capabilities

As discussed, for countries to succeed in their upgrading transition towards higher value-added chains, there need to be effective public policies in place that improve the overall investment-friendly business climate while also creating the conditions to absorb the benefits that FDI will bring in the recipient country.

The success of endeavours for combining the attraction and internalisation of foreign investment in Asia rests on the design and implementation of a robust investment facilitation and absorption mechanism. Investment promotion agencies play a key role in promoting, facilitating, and retaining foreign investment, although public officials are responsible for the good governance of investment facilitation according to a whole-of-government approach.

As countries face different stages of development and the respective challenges, the facilitation of investment is the key driver for attracting financial resources, developing basic infrastructure, and promoting connections with GVCs in lower-middle-income ASEM economies

For factor-driven economies, such as the Lao PDR, Myanmar, Cambodia, and Bangladesh, the facilitation of investment should take off with the projecting and branding of a positive image of the recipient country, which primarily lies on the quality of its institutions and the reliability of its non-discriminatory regulatory regime. Setting up an adequate investment climate for investors is a pre-condition for successful investment generation. A transparent, efficient, and predictable legal and regulatory environment is one of the most crucial

factors that foreign investors consider when deciding to mobilise their investments abroad – accompanied by political stability and security and an overall business-friendly environment. Similar to trade facilitation, investment facilitation too requires that a country streamlines, simplifies, and makes transparent its investment procedures. For instance, this can be achieved through a single window for investment, online systems for registrations, information portals providing information on how to start and operate a business, and aftercare services for existing investors.

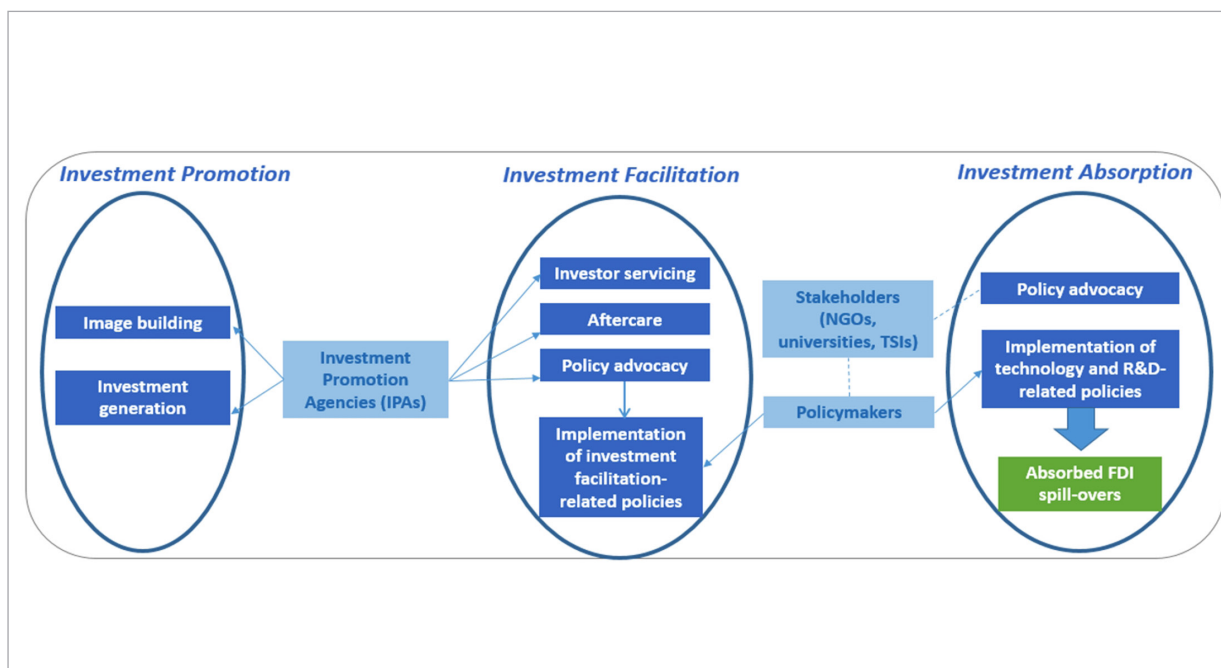
Adopting sound investment facilitation policies in ASEM's lower-income countries that have not yet leveraged their investment potential is crucial for entering GVCs and upgrading skills and processes. Strengthening a countrywide image of a reliable and stable investment destination, and making it easy for investors to establish, operate, and expand their investments, are key actions to be prioritised to attract FDI and foster the engagement of local firms in regional and global value chains. This entails adopting unilateral policies aimed at removing the regulatory restrictiveness in those strategic sectors where foreign investment is likely to generate the largest benefits for GVC participation, improving legal transparency and offering a comprehensive set of incentives to foreign investors.

Spurring economic growth and development at more sustained levels entails more than solely attracting investment. Upper-middle-income ASEM partners should foster the absorption of FDI in the domestic economy to master new highly technological products

To ensure the inclusiveness and sustainability of foreign investment, spillover effects of FDI need to be harnessed in the longer term by building the necessary skills of local firms to absorb the technology transfer and know-how and eventually master technology creatively in the production or design of high-quality, high-value-added products and services.

For efficiency-driven countries such as Thailand, Indonesia, and China, bolstering the capacity of domestic firms to internalise technology transfer is necessary to upgrade in the GVC. A third, absorptive layer that could complement investment promotion and facilitation could entail the implementation of technology and R&D-related policies that are aimed at enhancing the knowledge-based capital in the national economy of the recipient country (Figure 13).

Figure 13: Investment Facilitation and Absorption



NGO = nongovernment organisation, R&D = research and development.

Source: Authors' adaptation of OECD Investment Facilitation Framework, 2018.

This calls governments to design all-encompassing policies that are conducive for building synergies between industries, nongovernment organisations, education institutions, research centres, and government agencies to drive countries towards technological specialisation and innovation. Such policies could set forth capacity-building programmes designed to train the local labour force on how to master higher value-added technology while also investing in frontier R&D and organisational capital in upper secondary and tertiary education. Only a systemic approach to investment absorption will provide the fertile ground to maximise technological spillovers in the host economy, upgrading the GVC integration of local firms in more sophisticated production networks.

In the ASEM forum, policymakers could, therefore, elaborate agreeable standards of good governance and recommend best practices for enabling policies for a responsible investment climate. As a second step, the ASEM platform could inaugurate new processes to make these policies impactful through public-private dialogues, inter-agency coordination, and capacity-building for IPAs and other agencies.

The stakes of the direct beneficiaries of trade and investment facilitation reforms should be considered in the ASEM connectivity dialogue to ensure that reforms tackle the root causes of the challenges faced by traders and investors. To build a meaningful discussion, ASEM should promote the institutionalisation of public-private dialogue mechanisms to gather the

views of different stakeholders that are affected or likely to be affected by policy reforms. This will be especially crucial in the context of increased physical connectivity between Europe and Asia. To accompany improvements in physical corridors, upgrades in soft infrastructure will require the involvement of different economic actors – including traders, logistics services providers, trade support institutions, IPAs, investors, and border agencies – in the policy dialogue to ensure that it follows the whole-of-supply-chain approach.

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