

## Key Issues:

- Global value chain strategies have so far focussed only on barriers to the movement of goods.
- Services provision also matters for global value chain participation in manufacturing and in agriculture.
- The performance of service providers depends on the policy environment, but services policy restrictions remain high. Further reform offers significant benefits.
- There is resistance to reform, in the context of concerns about the adjustments faced by incumbent local service providers.
- Value chain thinking then offers new ways for local service providers to adapt to international competition and to build confidence in reform.

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## Services to Support Manufacturing Value Chains in East Asia

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*The drivers and consequences of the development of global value chains (GVCs) in East Asia have been the subject of significant policy research. This work has stressed the importance of efforts to reduce impediments to the movement of goods, and most progress so far has been made with respect to reductions in tariffs and efforts to facilitate trade, the latter led by the World Trade Organization Agreement on Trade Facilitation. Various projects led by ERIA have made significant contributions to understanding priorities for policy attention in these areas, for example, the work on production networks in South East Asia (Ing and Kimura, 2017). Services, however, are vital components of GVCs. This Policy Brief explains why services matter and makes policy recommendations to facilitate their role in value chain development in the region.*

### Why Services Matter

In GVCs, services facilitate the movement of goods through the application of transport services, they handle the flows of information required for the successful coordination of these chains, they manage the associated financial flows, and they support the movement of people involved in the management of the chains. Access to services that are competitive in world terms, therefore, is critical for the competitiveness of the chain participants.

Moreover, the value of locational advantages of chain participants, which contribute to their success, may instead be captured by inefficient services providers, that are either high-cost operators or operators that earn excessive margins.

Competitive services markets are important to remove these impediments to participation, and these inequities in the outcomes. They produce a more reasonable distribution of the benefits of participation in GVCs.

## What Policies Matter

Services can be provided in different formats. These are driven by the importance in services of arranging contact in some form between the consumer and producer, in order that the service can be provided. Some involve transactions across borders in terms of data flows. Others, like education, can involve the movement of consumers to producers. In the past, these formats have been relatively less restricted.

More important restrictions are generally found on the movement of producers to the home base of the consumer, through direct investment, or the movement of people who are service providers. Jusoh, Hamanaka, Ramli, and Narjoko (2019) identified the scope across sectors for reforms to remove barriers to investment flows and to facilitate the movement of people.

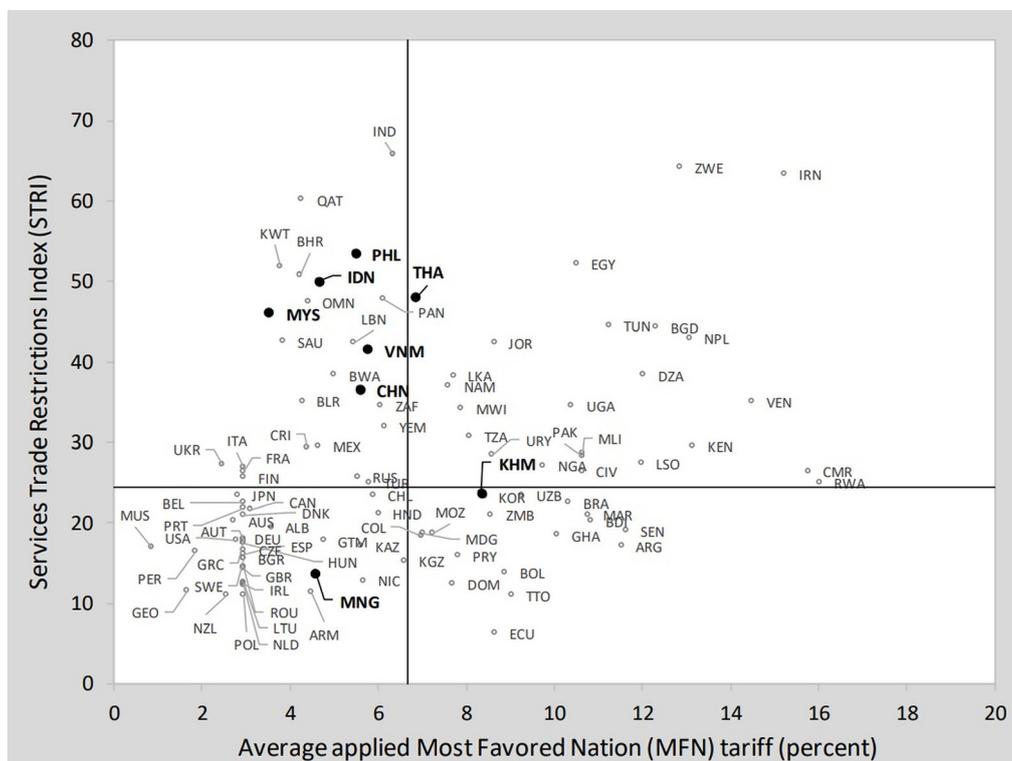
Action at the sectoral level is likely to be especially important. For example, Hoekman and Shepherd (2017) found the most important policies are those that restrict access to services markets through foreign direct investment (FDI) and that impact on transport and distribution services.

They estimated that the extent of exports by the manufacturing sector is reduced when the exporting country has a more restrictive services regime, the channel for which is its effect on productivity in manufacturing.

These results demonstrate the importance of services reforms. Yet, in East Asia, there is a disparity in terms of progress on reform of services policy relative to policy on goods. The World Bank (2018) has recently stressed this point in its report on 'A Resurgent East Asia'. The Bank observed that the progress on reform is asymmetric in East Asia (see Figure 1). Average tariffs are below the global median while the restrictiveness of services policy remains above it. Exceptions are Cambodia, which lies on the global median for services policy, and Mongolia which lies below it.

Beverelli, Fiorini, and Hoekman (2019) confirmed the productivity-enhancing effects of services reform. They also stressed the importance of complementary reform in other areas, since they found that countries with the best economic governance structures are the ones that benefit more from reform. A better governance environment will reduce uncertainties about the process of entering a market via FDI or operations thereafter.

Figure 1. Trade Restrictions on Services are High Relative to Tariffs



Source: Figure 13 in Constantinescu, Mattoo, and Ruta, 2018.

## Examples of the Impacts of Reform

An example of the impact of services reform is the case of Viet Nam, which from 2018 relaxed restrictions on foreign ownership in the logistics sector.

The consequence is reported to be a rise in FDI in that sector, including through mergers and acquisitions.<sup>1</sup> Even so, foreign ownership caps and restrictions on operations have not been completely removed. There are also reports that transport costs remain high, for example: 'the cost of transporting a container from Hai Phong 120 kilometres to Hanoi using a local company is three times higher than what foreign firms charge to ship a container from China or South Korea to Vietnam.'<sup>2</sup> These numbers imply there remains scope for further reform. Other issues in the sector, apart from remaining caps on FDI, are reported to be fees incurred by local firms which are not incurred by foreign firms, and difficulties in hiring skilled labour.

The case of reform in Viet Nam illustrates some important points about services reforms. First is the link leading from reform to foreign investment. This impact is a difference in services reform, compared to liberalisation in goods markets. In the latter case, opening up can lead to the replacement of local production with output from offshore. In the case of services reform, removal of impediments often leads to increases in investment and in employment in the reforming economy. This changes the politics of managing a reform programme. Second, domestic firms may be discriminated against in current policy compared to foreign firms: analysis of reform options should check for these possibilities. Third, efforts in complementary areas to facilitate adjustment are important: here the matter of concern is access to skilled labour, the supply of which depends on the education system and its responsiveness to structural changes.

The same points about the value of reform apply to the agricultural sector. Increasingly, agricultural production is connected by GVCs and linked to modern

<sup>1</sup> <https://www.vir.com.vn/foreign-investors-authorized-to-establish-wholly-owned-logistics-companies-in-vietnam-55454.html>

<sup>2</sup> <https://e.vnexpress.net/news/business/vietnam-s-logistics-sector-too-expensive-to-compete-with-foreign-rivals-experts-3698868.html>

supermarkets. Customer expectations of quality, in terms of standards, consistency, safety, and timeliness in delivery systems demands a high level of services inputs.

There are reports, for example, that investments in cold chain storage facilities have contributed to the growth of food exports in the Philippines.<sup>3</sup>

Where there is a change in foreign participation in services markets, there can be concerns about the competitiveness of local providers. The perception of their competitiveness also feeds into the willingness of an economy to open its services sectors. This is despite the evident benefits of reform for other parts of the economy and the benefits for employment.

Kohpaiboon (2019), a paper from ERIA's work on services value chains, found that Thai manufacturers are supported in their participation in GVCs by multinational logistics providers. He reports data on the value of contracting out to logistics providers and thereby their significance for Thailand's GVC participation. Multinational firms, however, tend to specialise in higher value-added activities, including the design of the chain.

Local firms tend to be more involved in specific and less integrated activities. Local firms could extend their range of offerings as they develop the human capital required. But one area where these firms already have an advantage is where knowledge of local conditions matters more, including warehousing, local movement of goods, and packaging. These are also areas where detailed knowledge of local regulations is important. There is scope for cooperation with the multinationals at these points, so there is a division of labour possible between local and foreign firms. In other words, a value chain could be better developed in the provision of the logistics service itself. Tackling the adjustment of local firms from this perspective could be an important facilitator for further reform.

<sup>3</sup> <http://supplychainasia.org/cold-chain-logistics-heats-phillippines/>

## Policy Recommendations

- For the development of value chains in goods, and to facilitate participation of new members, it is important to set a priority on the reform of services policies in East Asian economies. The target of this work is to remove the regional bias against services reform compared to the extent of openness in markets for goods.
- Generally reforms to policy on FDI and people movement are immediately important. Sectoral priorities include logistics and distribution. Complementary reforms that raise the quality of systems of governance amplify the benefits of reform.
- Services reforms may meet resistance from incumbent suppliers, but tackling the impediments to the development in services value chains themselves can assist adjustment and add to the competitiveness of incumbents.

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