

EXECUTIVE SUMMARY

World trade and production are increasingly structured around global value chains (GVCs). The emergence of GVCs during the last two decades has implications in many policy areas, starting with trade, investment, and industrial development.

The East and Southeast Asia region has been performing the role of ‘factory of the world’ for more than two decades. In 2019, East and Southeast Asia accounted for 18.4% of the global inward foreign direct investment (FDI) stock, concentrated at the country level, with China, Hong Kong, and Singapore each accounting for just over 25% of the regional total. Some small economies stand out as having very high rates of growth in inward FDI, such as Cambodia, the Lao People’s Democratic Republic (Lao PDR), and Mongolia.

FDI data disaggregated both by country and by source are not easily made available and have several degrees of confidentiality. However, investments by the United States (US) in Southeast and East Asia reveal that investments are mainly in manufacturing, services, and mining. FDI data for manufacturing are not easily obtainable, but chemicals and computers stand out as two sectors that are relatively important in all countries as they are regarded as classic GVC sectors – attracting higher investments.

GVCs are becoming increasingly important in the services sectors, although they are still less developed than in manufacturing. FDI in services also shows considerable heterogeneity across countries. Finance stands out in the higher-income countries as having a large share of the total FDI, although this is influenced by macroeconomic forces and tax and regulatory laws for holding companies.

FDI in the wholesale sector could be linked to GVC activity too. Distribution itself is a GVC sector in terms of logistics.

Inward FDI is overwhelmingly concentrated in larger firms in all countries for which data are available. While the proportions of small firms receiving inward FDI differ across countries, from an equity and inclusion point of view, it is important to be aware of the concentration of inward FDI on larger firms in the region, as well as the challenges that can pose for smaller firms.

The period following the global financial crisis has seen slower growth of trade relative to gross domestic product (GDP), and while GVC integration has continued to increase, it has done so more slowly than in the previous period. It is still too early to say to what extent GVC integration has been affected by the coronavirus disease (COVID-19) pandemic as rigorous data will only come out with a delay of some years.

Value chains are relatively robust to unexpected changes in trade costs. While the economic shocks related to COVID-19 are indeed severe, the implications of the pandemic are more macroeconomic in nature, with some difference across sectors. The incentive to source goods locally versus using foreign suppliers has not been fundamentally altered.

East and Southeast Asia are particularly well placed to take advantage of improved global demand later in 2021, given that these countries have generally managed the pandemic response very well.

The policy risk in some countries related to the debate over reshoring and the change in production locations may be low. A more likely scenario is targeted interventions in sectors that have assumed particular importance during the pandemic, such as health-related goods and vaccines.

In developing policy responses to the COVID-19 pandemic, policymakers must recognise the unique nature of the shock: it hit all countries at essentially the same time, and had broadly similar effects in each of them, at least in its early stages.

In this context, trade and investment policies require special review, as they determine the ability of firms to contest foreign markets or to source intermediate inputs from foreign suppliers. In the GVC context, trade facilitation can increase backward and forward linkages. Similarly, restrictions on FDI can impair backward GVC participation.

More domestically focused supply chains may not be the right approach to post-COVID-19 GVCs, as purely domestic supply chains mean that if a shock hits the local economy, there is no shock absorber, and the result is increased volatility. However, supply chain resilience is important for the production of public goods and necessities from a public health or safety perspective. Any policy intervention will need to balance the efficiency advantages of GVC production against any possible social objectives that are not fulfilled.

The bigger risk to economies in East and Southeast Asia is that recovery in the large, high-income markets of Europe and the US is slower than expected. Moreover, non-tariff measures in general have become more important determinants of market conditions. GVC development in East and Southeast Asia rests on a stable foundation of trade and investment links. Macro-level risks are relatively low, but at a micro level continued efforts in many countries to use non-traditional trade policies to introduce *de facto* discrimination against international suppliers may be a challenge ahead. GVC development in the region will not return to the rapid pace of integration seen in the early 2000s, at least in the short term.

The major potential change in conditions facing GVCs is the rise of the digital economy, environmental products, electric vehicles, or goods suited for increasingly carbon-neutral societies. Recovery programmes in the high-income markets will favour this shift through incentives and other measures. East and Southeast Asia is well positioned to take advantage of these opportunities, with some important incentives of retooling. Keeping markets relatively open, an effective supplier network, and integrated GVCs could be an important advantage for Southeast and East Asia in developing the GVCs of the future.