Chapter 5

Conclusions and Policy Implications

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CHAPTER 5

CONCLUSION AND POLICY IMPLICATIONS

Trade and investment in East and Southeast Asia from a GVC perspective reveal important changes in the GVC dynamics, especially in light of the COVID-19 pandemic, as well as other economic and social changes. The fragmentation of production across borders that is implied by the GVC business model, in particular the large-scale flow of intermediate goods and services, is not captured by traditional standard trade data, which overstate the value of trade, are incompatible with the system of national accounting systems that operate on a value-added basis, and do not identify the sources of value added. DVA, FVA, and PDC from domestic and foreign sources are the tools to assess changes in GVCs.

GVCs have a network of investment relationships underlying them. The taxonomy of investments in the GVC context is well understood from a policy standpoint, but the available data do not allow analysts to distinguish amongst the different motivations for an investment in GVCs.

In 2019, East and Southeast Asia accounted for 18.4% of the global inward 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 Mongolia, Cambodia, and the Lao PDR.

FDI data that disaggregate both by country and by source are difficult to obtain, and when available, as in case of the OECD, most of the contents are suppressed for reasons of confidentiality in the case of receiving countries in East and Southeast Asia. Most countries do not make this kind of data public, even if they track it.

This study uses easily available data of stocks of US origin investment in certain sectors in countries in ASEAN and East Asia. The distribution of US FDI is across the three main economic aggregates − manufacturing, services, and mining. Indonesia is the only country in the region where mining is a major source of inward FDI. By contrast, manufacturing predominates in Thailand and the Philippines, but FDI is mainly in the services sector in other economies. The balance between services and manufacturing is relatively close in Taiwan, Korea, and China. But in the remaining countries in Southeast Asia, the services sector is largely dominant in terms of hosting inward FDI.

In countries such as Thailand, where manufacturing is dominant, efficiency-seeking FDI is more prevalent. Comparative advantage effects predominate and the FDI in manufacturing GVCs is designed to serve the broader world market rather than the local market.

Countries where services dominate inward FDI represent an interesting middle case. GVCs are becoming increasingly important in the services sectors, although they are still less developed than in manufacturing. Inward FDI in services is linked to both efficiency-seeking and market-seeking rationale. Hong Kong or Singapore, which are technologically advanced but smaller markets, offer additional motivation – to acquire intellectual property.

While FDI data for manufacturing are not easily obtainable, in broad terms they show considerable heterogeneity across countries. Chemicals and computers, however, stand out as two sectors that are relatively important in all countries for which data are available, as they are regarded as classic GVC sectors – attracting higher investments.

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. Financial investments can, however, be influenced by macroeconomic forces, and tax and regulatory laws for holding companies. Nevertheless, finance is a service industry that has been relatively successful in internationalising its production process over recent years.

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, they are nearly always much smaller than the proportion of medium-sized and large firms. A partial exception is the Philippines, where a relatively large number of small firms has received inward FDI. From a GVC perspective, this pattern is normal as lead firms seek efficiency gains from suppliers that can work at scale. Smaller firms most commonly participate in GVCs only indirectly, as second-tier suppliers of larger firms that participate directly in GVCs. 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.

1. Emerging Issues for FDI in GVCs

The period following the global financial crisis has seen slower growth of trade relative to GDP, and while GVC integration has continued to increase, it has done so more slowly than in the previous period. The economic shocks associated with the COVID-19 pandemic have put stress on GVCs in various sectors, including some high-profile ones, such as personal protective equipment, vaccines, and other goods needed for responding to the pandemic.

It is still too early to say to what extent GVC integration has been affected by the COVID-19 pandemic as rigorous data will only come out with a delay of some years. But the available trade data show that there has predictably been a major drop in trade, particularly in services requiring personal contact. It is still unclear why recovery is happening at radically different rates in different countries. Even in those countries where recovery is lagging, it is unclear whether the proportion of GVC trade in the total has been affected. It is plausible that trade has fallen by a certain amount, but the fall was distributed over GVC and other types of trade roughly in proportion to their initial shares, which would mean that the relative prevalence of GVC trade would not change significantly. The ERIA-led survey of domestic and international firms in ASEAN and India largely confirms that supply chains have been impacted to some degree across the sectors, but the business outlook amongst firms remains cautiously optimistic.

Value chains are relatively robust to unexpected changes in trade costs. The proportional degree of cost increase required to cause GVCs to unravel is very high. While the economic shocks related to COVID-19 are indeed severe, it is unlikely that they are sufficiently focused on input markets to change firm sourcing decisions fundamentally. 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.

GVC activity will rebound rapidly as the global recovery takes hold. East and Southeast Asia is 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, and thus have seen fewer and shorter restrictions to economic activity than in other parts of the world, in particular Europe and the US.

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. These may not be of the same order of magnitude as reshoring large amounts of manufacturing activity.

From a GVC integration standpoint, technology (digital, robotics, and automation) has the potential to move production closer to the location of final consumption, but existing production locations are still preferred. At the level of firm decision-making, the pandemic experience will likely lead to a reassessment of the risks associated with dispersed production and just-in-time management practices, at least in those sectors that suffered stress. But it is important to note that while some GVCs experienced shortages and severe disruptions in the early stages of the pandemic, anecdotal evidence and limited surveys suggest that they resolved those problems rapidly and retooled to meet increased short-term demand for pandemic-related products. The private sector's reassessment of risk is unlikely to lead to a wholesale unravelling of the GVC business model. A likely scenario is the introduction of increased redundancies in supplier networks, to deal better with bottlenecks created by over-reliance on single sources.

In developing policy responses to the COVID-19 pandemic, policymakers would do well to be mindful of 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. As such, most countries saw a combined supply and demand shock because of the pandemic. But this pattern is extremely unusual. Finding the right balance between the efficiencies that come from concentrated sources and the need to mitigate risk is being evaluated. But there is no strong evidence of the need for policy intervention to supplant the normal course of decision-making within private businesses.

Trade and investment policies have come under review, nevertheless, 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. A more restrictive regulatory regime governing FDI is associated with a lower degree of GVC integration. Broader considerations concerning the business environment also play a role in structuring GVC interactions.

2. Resilient GVCs

Reshoring or shortening the spread of GVCs can be done through the imposition of unilateral trade tariffs and restrictive FDI policies, but are they useful or even required?

The unilateral US tariffs, to which China responded in kind, are very high relative to baseline levels, and have led to some unravelling of GVC linkages, but not a wholesale disintegration of the model. In the absence of policies designed specifically to disrupt production sharing – for instance, by targeting foreign input use rather than trade in general – it is extremely costly to radically alter the prevalence of GVC trade.

OECD (2020) showed that a more domestically focused supply chain, far from decreasing volatility, may increase it, as most economic shocks are not perfectly correlated across countries. Having a purely domestic supply chain means that if a shock hits the local economy, there is no shock absorber, and the result is increased volatility.

However, the issue of supply chain resilience is an important one, in particular when GVCs are used to produce public goods and necessities from a public health or safety perspective. There is evidence that the private sector is concerned with improving resilience in light of the vulnerabilities exposed by the COVID-19 pandemic. The focus, however, is on diversification, supplier redundancy, and technology, rather than large-scale reshoring. There may be a case for greater regulation of some GVCs on the grounds of assuring public health, but it will be important to assess these needs on a case-by-case basis rather than proceeding generally. Any intervention will need to balance the efficiency advantages of GVC production against any possible social objectives that are not fully fulfilled.

From the perspective of countries in East and Southeast Asia, there is some policy-related risk that large markets such as the US may seek to increase the proportion of DVA in production, although this risk has declined substantially with the new administration. There is a case for guarding their roles as suppliers within GVCs that ultimately export final goods and services to other markets, including the US.

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.

High savings and reduced spending opportunities may make funds available for investment, including in East and Southeast Asia, if profitable opportunities and expectations of future growth prevail. Sustained easy monetary policy in the high-income countries could create a climate where investors seek out opportunities abroad, including in East and Southeast Asia. Given the region's strong position as a locus of GVC activity, including through investment linkages, it would appear well placed to take advantage of such a shift.

3. Emerging Policy Issues

As tariff rates have fallen, NTMs in general have become more important as determinants of market conditions. Available policy data show that GVC development in East and Southeast Asia rests on a stable foundation of trade and investment links. Macro-level risks are lower because wholesale costly reshoring of activity seems unlikely. But there are still significant risks at a micro level, related to continued efforts in many countries to use non-traditional trade policies to introduce *de facto* discrimination against international suppliers. The slowdown observed since 2009 is related in part to these kinds of policies, and it seems likely that 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.

4. Post-COVID-19 Perspective

East and Southeast Asia has, in general, been very effective at containing COVID-19 from a public health perspective. But the economies of the region are generally very integrated in global movements of goods, services, ideas, people, and capital. A reduction in consumer spending may lead to reduced demand for exports. Information on the economic effects of the COVID-19 pandemic is still highly incomplete, as the situation is continuously evolving. The World Bank's Business Pulse Survey shows that falls in monthly sales have been large – up to 40% or more. In addition, up to 40% or more of firms are already in arrears on payments or expect to become so in the next 6 months (from June 2020, when the survey was conducted). For all ASEAN Member States, which have performed well in terms of managing the public health side of the crisis, COVID-19 has been a major negative shock to the economy.

Policy responses have been different in important aspects across the countries. Relatively few firms have received policy assistance in terms of access to credit, but tax reductions and exemptions – as well as cash transfers, payments deferrals, and wage subsidies – have been more common.

Subdued growth in production sharing seen since 2009 is a trend that has likely been reinforced by the COVID-19 pandemic. Trade has fallen substantially, and is likely to remain below trend for some time. FDI in developing Asia is also projected to fall by up to 45% in 2020. Given that trade and FDI are two of the main underpinnings of GVC development, the available evidence suggests that in the short term, GVC expansion will be more muted than in the 'golden age' of the early 2000s.

The main risk to GVC development in East and Southeast Asia comes from policy. Political economy pressures could combine to favour shorter supply chains, at least in some sectors. Reshoring in a major way appears to be very high-cost, especially where recovery is a key objective for the medium term. The most likely scenario is therefore not a wholesale reshoring of GVC production, but rather a continuation of the pre-existing trend towards slightly shorter value chains, and more tepid growth in production sharing than was seen in the early 2000s.

The major potential change in conditions facing GVCs is the rise of the digital economy, environmental products like renewable power generation equipment such as solar cells, and electric vehicles. 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, given its established base in related sectors such as electronics and motor vehicles. While retooling will be necessary, 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.

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