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## **CAPACITY BUILDING WORKSHOP TRADE AND TRADE POLICY ANALYSIS FOR THE POST COVID -19 RECOVERY**

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**TUESDAY, 7 DECEMBER 2021**

**10:00 - 11:15 AM BKK TIME (UTC+7)**

**THURSDAY 9 DECEMBER 2021**

**09:30 AM - 15:45 PM BKK TIME (UTC+7)**

**FRIDAY 10 DECEMBER 2021**

**13:30 - 15:15 PM BKK TIME (UTC+7)**

**VIRTUAL MEETING, MS TEAMS**



## **Narrative on Self-study 4: GVCs and Policy Issues by Dr. Biswajit Nag**

### **Module-4**

#### **Slide-1**

Welcome to the lecture on global value chains and policy issues.

#### **Slide-2**

GVCs are having direct and indirect connections with different policies as it is not only affecting the international trade but it is also having a significant impact on other policies such as industrialization policy or transport policy or policy on trade facilitation and Innovation policy. We have identified some of the major policies having a significant direct and indirect connection with GVCs. GVCs is based on the ideas of the possible gains from fragmentation of production. So, if there is more ease to trade, then the benefits from fragmentations will be reaped easily. Generally, multiple border crossing means more hassles and at the same time, if there is a drive towards protectionism then the cost of production goes up significantly. So more liberal environment is necessary for the reduction of the cost because components and parts can cross border several times. Many of the subsidies and incentives which are provided by different countries are becoming ineffective because many of them are incompatible. So, it becomes important to know what kind of policy incentives can be given to promote Global value chains. So, skill development, creation of knowledge, investment on R&D, promotion of services, setting-up of digital platforms are very important for facilitating GVCs. The rise of business-to-business transactions are also very important. So, in this context, promotion of FDIs is important in sectors where GVCs are spreading. In summary, we can say that better trade facilitation and competitive environment are necessary for GVC to flourish.

#### **Slide-3**

In this slide, we will make an attempt to expand the arguments. GVCs are developed due to the possibilities of fragmentation of production. The benefit of it is possible when the components and the parts can cross the borders easily. There could different types of tariffs and NTMs to restrict trade. Such barriers increase the cost of production easily, especially for GVCs. It is therefore important to know how the countries, governments, companies are coming together to negotiate these barriers for the products or the sectors for which GVCs are being developed. Several traditional policies on taxes and subsidies which are not WTO compliant are difficult at this moment to continue with. Government now should think of new policies so that GVCs are still getting support, especially in the development of MSMEs. So many new policies like creation of new economic zones, trade facilitation, investment in R&D or development external economies of scale are extremely important can enable in GVCs to grow. Service sector to facilitate GVCs is very important. Logistics, transport and communications are very important. Several Business and Professional services are also growing, even Professionals are moving from one country to another country. Therefore, the competitiveness of the service sector is extremely important to improve the quality of value chain.

#### **Slide-4**

Further, increasingly, the GVCs are becoming knowledge-intensive, production processes are becoming more like routine activities and around the production activities other issues like design, product planning, conceptualisation of new product when there are feedbacks from customers, thus enables in making the entire process more knowledge intensive. So, it's very important that there are set of policies by which countries can promote the skill of firms to adapt new knowledge and the firms in turn can develop the requisite skills among the

employees. Because of the fragmentation and outsourcing and sometimes some of the critical and non-critical activities are separated from OEMs. And sometimes it requires FDI to move to those countries in that particular sector from where the goods are being outsourced. And these kinds of investments should be promoted it because these investments can generate lot of development benefits such as employment generation, technology transfer and help SMEs to develop new network. Comprehensive trade agreements can also help as there has been rise in regional value chains, thus increasing GVCs in the established sectors or planning to develop. There can be policies for skill development and digital platforms so that countries can procure components from other countries.

#### Slide-6

We can see that trade in intermediate goods and intermediate services is significantly high. It's not just the good but also the intermediate services that people trade. Almost 70 per-cent of the international trade consists of range of transactions which include services, raw materials, parts and components which have changed the character of international trade throughout the world. Hence, it is very important to support this fragmented production process so that more goods and parts and components are traded. So, trade policy needs to develop a complimentary policy both for manufacturing and services. For example, the industrial policy can look into the transport policy and Innovation policy and similarly the trade policy can look into investment policies as well. So, this kind of overlapping of the policies are essential to support the fragmentation process.

#### Slide-8

As mentioned before that more protectionism means more cost in crossing the border. Therefore, the figure here explains that there are direct and indirect tariffs on input and tariffs on final exports. As can be seen that both direct and indirect tariffs on inputs are a significant portion of the tariff on the final goods. In accumulated form, total tariffs will be contributing a significant proportion of the cost. And that it is very important that there should be a discussion among the countries who are developing GVCs to address the possible reductions of both tariffs and NTBs.

#### Slide-9

The benefit of currency depreciation can go down if there are significant costs in crossing border. In recent times, there has been resurgence of tariffs, fuelled in part by tensions between the United States and China. And this has costed GVCs of 3-5 years of growth slowdown. Further, during the covid pandemic, the fear of supply-chain bottlenecks has increased. And we have seen lot of restrictive trade policies which further reduce the growth of GVCs. Also, in recent times the cost of shipping is increasing, pushing the consumer prices. GVCs will remain in the core of the economic recovery as many studies have identified. This is due to hyper specialisation and it's very difficult to go back to completely vertical structure within the country, it might be taking a very different shape, but it's very difficult to say that GVCs will cease to grow.

#### Slide-11

Traditional incentives such as tax breaks, subsidies, etc help to overcome a market failure (such as information asymmetries), address a coordination failure (such as requirements for complementary investments in supply chains), or help capture an externality (such as technology spill overs). And many countries having policies to develop MSME sectors as supplying sectors connecting to GVCs through different kinds subsidies structure, many of

which are WTO incompatible. Therefore, there is need to understand how we can allocate capital in developing this sector further. So, one of the areas where investments are lacking is basically in promoting R&D and external economies of scale. And also investing on skills and trade facilitation. Rather than providing subsidies to firms directly, if governments can give their attention to these areas, then this might help the sectors as well as their competitiveness in moving up the value chains.

#### Slide-12

We can see that currently subsidies are contributing to 29% of the distortion in policies and tariffs measure 17%. Many countries are also having a 'local content requirement' policy because countries want to develop backward linkages, however it should not be considered as a general policy for all sectors. So, countries need to be very clear in which sector they can develop the backward linkages and in which sector they can allow the backward linkages to develop naturally. So, in some cases the local content policy be required and in which sector it is not. Apart from the backward linkages, the sectors should also look for possible forward linkages so that they can improve the domestic value content in the export. And for that cooperation between the government and the private sector is extremely important.

#### Slide-14

So, trade facilitation is one of most important drivers of GVC growth. Investment on trade facilitation is absolute necessary for GVCs. Countries who have performed well in GVCs, they had wonderful logistics infrastructure and therefore these countries are the ones with high level of logistics performance and ease of doing business. Lean inventory, faster turnaround, good internal logistics, fast border clearances, less paperwork, etc are essential for GVCs to flourish.

#### Slide-15

It is important to note that the shipping delays are more for the products having complex value chains, for example if you look at the automobile, food products, chemicals because of the standards, conditions, licensing, quality parameters, etc. So, streamlining those policies can help to improve the trade facilitation structure in general. Also, countries need to link with other countries which are poor, remote, landlocked because sometimes the cost of production are lower and even wage rates may be much lower, there could be easy access to land and special economic zones, extended cargo terminals, can be developed easily. However, there could be 'chicken and egg' problem. These places are not developed and hence, international connection ( direct shipping) is weak. Also, as the connection is weak, the places are not getting sufficient investment to develop. The issue requires special attention, as we can expand GVCs to these countries. For example food and nutrition value chain in pacific islands are helping them to grow significantly and even horticulture can be developed easily through a better technology and speedy transportation with other countries such as Australia and China.

#### Slide-17

Service-led development during post globalization period especially through digital platforms is extremely important because the developing countries which are typically well endowed with low-cost labour are currently seeing a major challenge. In many cases even the production processes in those countries are gradually becoming more capital-intensive which requires lot of complementary services for better performance like transport, logistics, finance, professional services such as engineering, design services, and service of highly skilled workers etc. As shown in Figure, the value created by services as intermediate inputs account for 30-35% of the total value-added in manufacturing exports. More efficient service sectors

enhance the competitiveness of manufacturing firms. So, distribution services include warehousing, retail and large employment can be generated. And there could be technologies for quality control. Therefore, investments in these areas can improve the performance of GVCs.

#### Slide-18

So, some of the services can be liberalised for example transport services, warehouse or inventory management services, etc. If domestic efficiency is sub-optimal, private sector including foreign investment can be encouraged in this area. Services play a crucial role in the production process. Engineering services like maintenance of big machines through IT-enabled services, automation of processes etc push for 'servicification' of the industrial process. Some of the services can also be outsourced from other countries. So, two countries where this example works are India and Philippines. Both are now among the leading countries for offshore business services worldwide because of their low costs, human capital availability, and attractive business environments for services sectors. India started with call centres and normal BPO services and now it has moved to high end data analytics for banking, insurance and FMCG companies. Indian companies are also contributing in developing Artificial Intelligence (AI) services.

#### Slide-20

It can be seen in the figure, innovation plays a very important role in the sectors which are champions in GVCs, like pharma, machinery and equipments, electronics, computers automobiles. Upstream activities like R&D and design, as well as downstream activities like distribution, marketing, and after-sales services (especially for FMCG companies), are contributing in value generation. So, in cases, especially for pharmaceuticals and consumer electronics, many companies outsource the entire production and just manage the brands. In pharmaceutical sector contract manufacturers are present. In case of consumer electronics, production is done by small companies under the guidance of big companies. As a result of this, even the MSMEs need to comply with technological standards demanded by OEMs. On the other big companies try to manage the brand, codify the process and manage the intellectual property (IP).

#### Slide-21

We require an enabling policy even in the developing countries so that labour force can quickly adapt to the new technologies because MNCs keep on changing the technologies to support the demand globally. So, what we require is significant investment on the skill level and robust IP laws. So even small and developing countries need to invest on knowledge to become part of innovations which will not only help MNCs, but can also improve the productivity of MSNEs. Additionally, this can help them to diversify further and develop new product. The coordination between big firm and MSMEs will be crucial. Also, policy hurdle should not be there.

#### Slide-23

FDI can help to get new technology and help productivity to increase and enable many more innovations. This is more important if the firms are part of GVCs. In that case it is important to have investor friendly trade policies. So that domestic rights and investor's rights are protected. In general, there should be a better regulatory environment and attractive FDI policies so that's GVC sectors also get FDI. So, governments can play a great role in bringing together

MSMEs together. There can be middle companies to connect MNCs with MSMEs. These can be identified to link with GVCs.

#### Slide-24

Lack of financing is one of the major challenges faced by small players because to be in GVCs, investments are required to bring in technology, skilling the workers and networking. On the other hand, lead firms face challenges such as customs procedures, high import duties, licensing requirements, pre-work, and domestic standards. Transport cost and warehousing capacity are troublesome for both small and big firms. In this, government can play a crucial role in bringing these companies in one place and help in developing hand-holding programmes. Research shows that direct technical assistance from lead firms—either through formal linkage programs or as part of the normal firm-client relationship—is one of the biggest sources of spill overs to local suppliers. For local SMEs to absorb spill overs from GVC participation, ongoing investments are required in technology, process improvements, and training.

#### Slide-26

As we have seen that GVC literature is highlighting the rise of regional value chains. In this the lead firms, to reduce the risks they are spreading their arms to the neighbouring countries so that cost related to distance can come down. Therefore, trade agreements with neighbouring countries are becoming a driver for GVCs. So, one of the most important things are the negotiation on customs barriers and rules of origin. Therefore, these conditions can be taken into consideration while negotiating trade agreements. In some cases, sector level discussions are also very important.

#### Slide-27

While looking at Asia, North America, the ratio of regional to GVC is very high. On other hand European regional value chain is coming down. So, regionalism is most apparent in global innovation value chain, in promoting the idea of JIT. This can have positive influence on other value chains.

#### Slide-29

Some of the complementary policies which are essential for GVCs to develop is discussed here. One of them is employment generations and skill development. If there is focus on special kind of skill development (for participating in GVC), large investments in those sectors can help specialised suppliers to grow. This can lead towards economies of scale. With the presence of many such suppliers in the economy, there will be benefits through labour market pooling and knowledge spill over and thus investment on human capital is essential.

#### Slide-30

Let us now talk about firm capability in managing new business environment to sustain the pressure of productivity and profitability growth. For example, IT driven accounting system, inventory management, networking, responding to demand (buyer management) and how to report the quality standard, etc require new kind of capability. To enhance such capability, modern business and dynamic engineering education is necessary. University and Engineering college education need to be revamped so that firms also get the benefit from educated employees. This can also help in developing local R&D culture. So, universities/research institutions, Governments and firms must be brought together so there is a synergy among the stakeholders which can complement the growth of GVCs

#### Slide-32

Some firms are born global firms. These firms have not gone through the turmoil of structural change. These firms have taken the advantage of digital platforms and they can connect with the world easily. It is not the case that these firms first need to sell locally, gain experience and then think about global market. Now because of internet, many countries have developed digital platforms for SMEs. Global buyers can access small local firms through such platforms. In many cases platforms also ensure quality of the products. Also, Platforms create “network effects,” meaning the more users a platform reduces the cost of doing business because firms can access more SMEs easily and SMEs can showcase their products to more global buyers.

#### Slide-33

So, these can help in new value chain to develop because of digital platforms and e-commerce, especially for B2B transactions. At the same time huge amount of data is collected, which can be used to generate value helping firms to develop new products and new strategy. Therefore, this helps MSMEs in GVC to get nuanced information which can be used for advancement of their business. Promoting MSMEs through digital platforms can also be a good strategy to link them with GVCs.

#### Slide-35

GVCs are having hidden vulnerabilities and are exposed to trade wars and pandemic. So, these shocks can be political, or natural. It's important for us to anticipate the direction in which GVCs can move. Although, some sectors are more resilient, because of demand surge such as pharmaceutical and IT products, but some sectors are having demand shocks such as tourism, transport. So, when we think of rebalancing GVCs we need take into account the fact that some sectors have an advantage over others due to the changing nature of demand during the pandemic.

#### Slide-36

This slide shows that slowing down of GVCs have started even before the pandemic. Value chains become less fragmented now. There is a shift towards regional value chains and slowdown in FDIs and decline in global trade also contributed in shrinking of GVCs. We also observed agglomeration/consolidation of tasks by some mid-line companies which is also responsible for reduction of GVCs as percentage of trade

#### Slide-37

Building supply chain resilience can take many forms beyond relocating production. This includes strengthening risk management capabilities and improving transparency; building redundancy in supplier and transportation networks; holding more inventory; reducing product complexity; creating the capacity to flex production across sites; and improving the financial and operational capacity to respond to shocks and recover quickly from them. For e.g. China through its neighbourhood policies have developed ASEAN as strong trading partner. Lesser distance, cultural similarity, understanding of local business environment help China to manage the risk of GVCs effectively.

A shift in investment promotion strategies towards infrastructure and services is necessary. For the past three decades international production and the promotion of export-oriented manufacturing investment has been the pillar of development and industrialisation strategies of most developing countries. Investment geared towards exploiting factors of production, resources and low-cost labour will remain important, but the pool of such investment is shrinking. A degree of rebalancing towards growth based on domestic and regional demand and on services, as well as the green and blue economy, will be the new path forward.

#### Slide-38

Internet-driven GVCs are diminishing the importance of physical stores and retailers, a trend that has been magnified by the COVID-19 pandemic. Internet-driven value chains have also added important new dimensions, including the two-sided market where customers can directly contribute their feedback to sellers or manufacturers, thereby influencing future product development and output. This has significant implications for the labour-market space.

Internet-based virtual intermediaries replacing physical intermediaries, such as brick and mortar stores, the displacement of clerks, store managers and other face-to-face service providers, is accelerating—and entailing a remarkable shift within the spectrum of demand for services jobs. Some jobs will vanish and new kind of jobs will surface.

Internet-based virtual intermediaries have developed whole new value chains, such as the data-driven value chain for the generation, processing, and sale of data. Companies can access those information for developing new business strategy.

COVID-19 pandemic has both expanded e-commerce and underscored the fragility of some supply chains. This has revealed the need for diversity to accelerate resilience, which may prompt the reconfiguration of the GVC landscape, including near-shoring, regionalization, and reshoring. There is a strong focus on regionalism in this direction.

Finally, the emerging digital platforms have an huge impact on sourcing, production, marketing, distribution, and service networks. This will likely continue to be crucial for shaping GVCs in the future.

Thank You.



