Preface

Leveraging trade in order to expand formal employment opportunities, generate greater value addition, assist export diversification across products and markets, enhance resilience and support the development of productive capabilities is an aspiration of all Commonwealth governments. These objectives were conveyed clearly at the Commonwealth Trade Ministers Meeting convened in March 2017.

The first *Commonwealth Trade Review* (Commonwealth Secretariat, 2015) revealed that the 'added value' of the Commonwealth was related to the common institutional frameworks that existed between members. Realising the potential to further leverage the 'Commonwealth advantage' on contemporary trade and investment flows and linkages requires further reflection on the possible trajectory of future fragmentation processes. The think pieces included in this volume, contributed by policy-makers and academics from across the Commonwealth and beyond, are intended to enable precisely this reflection.

In this publication, as well as taking stock of past performance, we reflect on potential future dynamics. The chapters collated in this publication provide for a more careful examination of GVCs within which our members specialise at the sectoral level: manufacturing, services and commodity trade, including within the realm of the oceans economy. Given that the overwhelming majority of the 52 Commonwealth member countries are small states, 45 are oceans states and around one-fifth are least developed countries, understanding how dynamics are unfolding at the sectoral level is critical to encouraging more gainful GVC participation.

We now face a very different global trading landscape compared with in the past. Contemporary trade manifests itself in specific tasks, with operations and production processes fragmented and geographically disbursed. In view of these trends and through a more inductive approach, one that involves learning from experiences across the Commonwealth of existing GVC participation, a clear set of policy measures becomes apparent. These include overcoming barriers to entry, informational asymmetries and unfair competition, and stimulating innovation.

There are areas of mutual interest and where enhanced co-ordination could enhance trade gains. Given that the ability to transmit tacit knowledge through Commonwealth trade, finance and investment networks in view of our common language and institutions is inherent in the demonstrable effect of the "Commonwealth advantage" it suggests that the translation of already known best practice into transferrable and non-tacit forms through the sharing of toolkits and frameworks could further enhance the gains from closer collaboration. The necessity of doing so is heightened in view of the advancement of the SDGs.

Governments have to better understand corporate strategies if they are to effectively engage with GVC trade. The achievement of structural economic transformation within the context of GVC trade entails system-wide approaches, more cognisant of innovation systems, as opposed to more siloed approaches towards sectoral development. Concerted action is required to facilitate interactions between private and public agents, so as to effectively enable social upgrading processes.

This publication is organised as follows:

- In Section 1, we reflect on global developments likely to influence future fragmentation processes and the possible trajectory of the GVC mechanism.
- In Section 2, we discuss thematic issues with particular relevance to Commonwealth members, including the interface between trade, institutions and regulatory frameworks.
- In Section 3, we summarise sectoral developments and changing dynamics affecting some of the major value chains in which many Commonwealth members trade.
- Section 4 presents three alternative policy perspectives on effectively engaging with the ascendency of GVCs and future fragmentation processes.

The main findings from each Section are summarised in the following sub-sections.

Section 1: Global developments

There is increasing recognition that the wave of fragmentation that has underpinned the GVC mechanism in recent decades may have reached its limit. This realisation, along with other noticeable trends, such as the increasing pace of growth in trade in services compared with that in goods, has prompted a period of introspection in the international trade community. Although some of the national-level actions that have emerged as a result of this realisation resemble forms of protectionism, the overarching objective in most cases is to enhance domestic value addition processes and bolster productive capacity.

The chapters in this scene-setting section of *Future Fragmentation* intend to draw the reader's attention to developments at the macro level that are likely to influence future fragmentation processes and the possible trajectory of the GVC mechanism. They also provide for a more careful examination of GVCs at the sectoral level, covering manufacturing, services and commodity trade. Given that the overwhelming majority of the 52 Commonwealth member countries are small states, and around one fifth are least developed countries, understanding how dynamics are unfolding at the sectoral level is critical to encouraging more gainful GVC participation.

In the first chapter, **Wignaraja** draws attention to the profound shifts that are under way in the GVC fragmentation mechanism and in the role of 'Factory Asia'. This includes the structural shift in China's growth pattern, which has become less dependent on investments and exports; the increasing role of regional economies within GVCs; and the surge in trade protectionism that has become apparent in recent years. Wignaraja argues that, as a result of the combination of these developments, the GVC fragmentation mechanism has entered a new phase. As a consequence, trade-led growth models require some refinement as firms modify their business strategies within the more supportive domestic frameworks governments are providing. Proactive foreign direct investment (FDI) strategies are required to leverage the potential of digital trade. A greater focus on the process by means of which firms join GVCs, including the implications of mergers and acquisitions for firm growth and the building of technological capabilities, is also required.

In the second chapter, **Sturgeon, Farole, Ortega Moncada and Pietrobelli** describe why distance exerts a strong influence on GVC participation, in part because of the costs of co-ordination and a reduction in the exchange of tacit knowledge arising from interactions between buyers and sellers; distance can, therefore, reduce the potential for 'learning by exporting'. Although small states may find it easier to insert themselves into GVCs through specialisation in a narrow range of tasks, overcoming some of the challenges of distance requires strong interventions designed to foster exposure to high-value activity hubs that specialise in research and development and marketing, with targeted skills development and active linkage development. In this regard, particular emphasis is placed on information and communications technology (ICT) and connectivity. These technologies transform not only conventional business models but also how buyers and sellers interact.

Finally, **Nissanke** describes how commodity markets have developed in recent years, with a deepening relationship between commodities that are traded physically (by transnational corporations) and those that are traded virtually (within derivatives portfolios on financial markets). The combined effect of these transformations has altered conventional processes of price discovery and risk-hedging, with implications for managing price volatility at the producer level. To counteract some of these potentially adverse effects, producers should pursue mitigating strategies. The aim of these should be to broaden learning and knowledge accumulation processes and reinvigorate productive investments. Invariably, this entails critical reflection on the institutional framework within which GVCs operate.

Section 2: Thematic issues

Since the beginning of the twenty-first century, the primacy of institutions in driving the trade–growth nexus has been at the forefront of development thinking. However, as **Keane** argues, only recently have institutional variables and public policy frameworks been paid greater attention within GVC analysis, as opposed to being relegated to the 'background'. Although global public policy aspects, notably social and environmental ones, have achieved greater prominence since the adoption of the SDGs, the operationalisation of these goals across fragmented regulatory spheres continues to be subject to scrutiny and debate.

Because the transformation of global production through firms' internationalisation strategies has fundamentally altered the conventional profit–investment nexus, more careful consideration has to be given to the institutional context within which firms trade and interact. These interactions—between public and private sector actors—must be contextualised as part of processes of technological advancement and societal learning within a broader innovation system. In order to facilitate these processes, trade governance structures have to adapt.

Within this context, **Low** reflects on the role of services in enabling particular types of upgrading in GVCs. Value-added estimates of trade are transforming our understandings of the contribution made to total trade by services. A tendency to define regulatory structures that affect goods, services and investment in separate policy compartments interferes with the relatively seamless nature of interaction among these aspects of GVC activity. Within the context of contemporary trade patterns as manifested in GVCs, rules across different modes of services supply need to be defined and applied with greater consideration of their interconnectedness, rather than being formulated in silos. The assignation of policies individually to modes of supply reduces policy neutrality. This can serve development objectives in certain cases, but it can also undermine them.

Better understanding company ownership structures, as well as where 'substantive activity' takes place, has major implications for public policy aspects, including taxation. Given this reality, the contribution by **Rutherford** reflects on the participation of small states in GVCs. This includes their role as providers of high-value services to multinational corporations through hosting International Financial Centres, thus facilitating tax efficiency.

Although this position within GVCs has been advantageous in the past, it is coming under increasing strain.

Business models are changing. This means there is a need for consideration of new strategies for diversifying into other high-value services. The current investment and regulatory regimes in many Commonwealth small states have to adapt to these regulatory shifts. This includes building on existing comparative advantages and capabilities to facilitate movement into other high-value services, as they begin their fragmentation processes.

Section 3: Sectoral developments and changing dynamics

The recycling of comparative advantages between trading partners located within the current dominant hubs of global economic activity (Asia, the EU and the USA), and particularly within Asia, was underpinned by a process whereby the functions disbursed from lead firms, through offshoring or outsourcing, enabled the release of resources to facilitate their upgrading processes. This process has been described as the 'flying geese' model of trade-induced economic development.

In the future, the Chinese process of recycling its comparative advantages within manufacturing sectors will be known as the 'flying dragon'. However, the evidence presented in the sectoral case studies in Section 3 demonstrates how similar processes are now being replicated across other regions and sectors in the Commonwealth as firms begin their internationalisation strategies.

The case studies referred to in this volume range from soft agricultural commodities to capital-intensive industries (e.g. the automotive industry) and traditional services industries, such as tourism. The issues highlighted in each of the case studies highlight new situations related to changes in business models and the emergence of tiers of suppliers. These include contractual issues, effective competition management and the process of technological innovation and adaptation.

We begin with a review of sectoral developments within what are referred to in the literature as additive value chains, where value is added at each sequential stage of the production process. These types of value chain are typical of the commodities sector. The chapter by **Struthers** analyses the changing dynamics within commodity markets and increasing price volatility using a principal–agent framework. Adopting this form of micro perspective helps shed light on the role of informational asymmetries within trading relationships and how contractual arrangements may influence these.

More fundamentally, this chapter reflects on how the fragmentation of production processes within commodity markets has influenced the transmission of information. In some cases, this has increased the scope for opportunistic behaviour. To address some of the challenges that could result from information asymmetries, a number of options to advance the compatibility of incentives are identified. These include greater consideration of contractual arrangements, price risk management instruments and the creation of commodity exchanges within producing countries.

The chapter by **Dihel and Shahid** provides evidence of structural economic transformation induced through GVC participation, within sectors and different types of value chains and with alternative contracting arrangements. This is in contrast with the traditional understanding of the achievement of structural economic transformation across sectors. The chapter presents the results of pilot studies undertaken in agricultural value chains in Africa. These studies find divergent patterns of structural transformation within sectors, induced through value chain participation and mediated by alternate contractual relations.

Through a focus on maize, cassava and sorghum in Ghana, Kenya and Zambia, the results help shed light on the specific policies and types of contractual arrangements that can assist in supporting the movement of producers (farmers) and upgrading processes towards higher-value intermediate processes and final outputs, which result in higher and more stable incomes. Within this context, the results from the studies suggest a greater focus on strengthening regional value chains (RVCs), particularly in the agriculture sector.

Further to this introduction to entry-level stages of GVC participation, sectoral developments within high-value agriculture GVCs, including processed fisheries, are explored. The chapter by **Nana Asante-Poku** examines how domestic and external factors interacted over time to influence Ghana's participation in the pineapple GVC. Asante-Poku compares experiences between 1984–2004 and 2005–13 to illustrate how institutional changes have influenced relationships between second- and third-tier suppliers and firms. The chapter describes how participation within the pineapple value chain initially grew over time, but also how a failure to adapt to major changes (including the introduction of new varieties) in the international market inadvertently led to a subsequent decline. Within this context, lessons are derived regarding addressing financial constraints, which, it is argued, constrained Ghana's ability to respond effectively to dramatic changes in the external market, leading to the ceding of a large portion of market share over time.

Trade preferences into the European market have historically provided a strong incentive to diversify away from commodity dependency and enable a shift towards other forms of high-value agriculture. The chapter by **Keane** explores these aspects, reflecting on the participation of the incumbent Kenya and the more recent entrant, Ethiopia, in high-value agriculture and the subsector of cut flowers. The emergence of tiers of suppliers is clearly apparent in the case of Kenya; these act as intermediaries, controlling production and supply to retailers. Some Kenyan lead firms are also active in Ethiopia. A type of 'flying geese' model is described as being in operation within the East African region. The implications of these recent trends are contextualised in terms of contemporary understanding of conventional upgrading processes within GVCs—notably the need to facilitate productive investments. The dual processes of economic and social upgrading require close linkages between the public and the private sectors within a type of innovation system, which requires adaptation to cross-border linkages between firms.

The chapter by **Campling** explores the interactions between international trade regimes, the tuna GVC and the attainment by small island developing states of SDG 14, Life Below Water. The nature of the tuna GVC, with retailers often playing suppliers off against each other, can lead to cost pressures being transferred to boat owners further down the chain. These trade challenges, which arise from the nature of organisation and co-ordination within the tuna GVC, are considered alongside other long-standing trade issues, including those related to harmful fishing subsidies (SDG 14.6), which create an even more unlevel playing field for small states. In addition to addressing this aspect of unfair competition—while preserving aspects relating to special and differential treatment—the chapter outlines a number of areas in which actions could be taken to increase the economic benefits derived from this sector.

Moving up the technological sophistication ladder, we then proceed to analyse sectoral developments within the textiles and clothing GVC, with a particular focus on Sub-Saharan

Africa (SSA). This sector is the archetypal 'vertically fragmented' value chain. Vertically specialised chains result from the fracturing of production processes, with firms increasingly specialising in their core competences and outsourcing their non-core activities. This leads to the fragmentation and slicing-up of production into a myriad of sub-processes, which can be undertaken in parallel.

The chapter by **Staritz, Morris and Plank** describes how the rise of textiles and clothing GVCs in SSA is generally perceived as a successful process of beginning the industrial development process through leveraging preferential market access and attracting FDI. However, aggregated analysis of SSA clothing exports masks some crucial differences: end market shifts; the emergence of RVCs; the variety of firm types included in different value chain channels; the political–economy dynamics driving this; and the related sustainability and development implications. This chapter identifies the different types of firm in the textiles and clothing industry—transnational, regional, diaspora and indigenous—in SSA and their implications for conventional upgrading processes.

The chapter by **Barnes** presents a framework for developing countries with automotive industries, or those seeking to establish them. It assesses the implications of the emergence of different dynamics within the sector. These changes include the domination of value chains by a small group of Tier 1 suppliers; stricter environmental and safety standards; and, finally, growth in emerging markets and the potential for RVC development. These developments serve to reinforce a focus on the development of technological capabilities. Although the provision of subsidies by governments can facilitate entry into the automotive value chain, over time these aspects become less important compared with the development of specific capabilities within the sector.

The final chapter, by **Nurse, Stephenson and Mendez**, explores the scope for economic diversification within the tourism sector. By adopting the GVC perspective, this chapter explores the linkages between different services sectors and tourism to identify opportunities for upgrading to higher-value activities. Cross-border services activities in the tourism sector include the online services provided by tour agents. However, despite being of tremendous value, the linkages between this type of service and the conventional tourism value chain are not always considered. Other forms of tourism services, including commercial presence, are also not exploited. The evidence presented in this chapter suggests that more effective upgrading processes for the tourism value chain include consideration of the linkages between different modes of services supply.

Finally, some of the main findings arising from analysis of trade in value added in African, Caribbean and Pacific countries are presented, the main highlights of which include the following:

Caribbean[1]

- There was a consistent increase in the proportion of foreign value added embedded within the exports of Barbados, Belize, Guyana and Jamaica between 1995 and 2000.
- The main sectors that experienced an increase in foreign value added in exports (2000–12) were transport; food and beverages; post and telecommunications; private households; and maintenance and repair.
- The main sectors that experienced a decrease in foreign value added (2000–12) were mining and quarrying; electrical and machinery; textiles and apparel; fishing; and public administration.
- This suggests declining participation in archetypal GVC sectors, such as light manufacturing and processed fisheries.

- A consistent increase in domestic value added in exports occurred between 1995 and 2012 in the case of Antigua and Barbuda, The Bahamas and Trinidad and Tobago. However, domestic value added by Caribbean countries as a proportion of global trade in value added (2000–12) decreased, except in the case of Trinidad and Tobago (driven by the dominance of petrochemical exports).
- Global value added to exports (through imports) increased between 2000 and 2012 by almost 10 percentage points, with a slight decrease in the regional sourcing of value added from other Caribbean partners (0.02 per cent).
- However, individual countries in the region (Barbados, Guyana and Jamaica) have increased their sourcing of regional value added, mostly from Trinidad and Tobago.

Pacific[2]

- Between 1995 and 2012, Fiji and Papua New Guinea increased the proportion of foreign value added in their exports. Australia and, to a much lesser extent, New Zealand, by contrast, experienced a decrease, and the proportion of domestic value added in their exports increased.
- Globally, the value added contribution of Australia to world exports has increased dramatically in recent years, whereas that of New Zealand has decreased.
- Overall, the regional contribution of value added to global exports has increased, from around 3 per cent (2000) to 7 per cent (2012). Australia is the only country that has not increased regional sourcing of value added.
- Each of the individual countries of the Pacific increased their sourcing of value added from Australia between 2000 and 2012.
- The sectors with the largest increases in foreign value added in exports (average percentage point change) include agriculture; mining and quarrying; post and telecommunications; hotels and restaurants; and, construction.
- The sectors with the largest decreases in foreign value added (and hence where domestic value added may have increased) were financial intermediation and business services; petroleum, chemical and non-metallic mineral products; education, health and other services; wood and paper; and, retail trade.

Section 4: Policy perspectives

In view of the new evidence of participation in GVCs by the Commonwealth, and changes over time, it becomes clear that far more nuanced and country-, as well as region-, specific approaches towards more effective and gainful GVC engagement are required. Given this context, we introduce four alternative, but also complementary, policy perspectives.

Kaplinsky affirms the primacy of economic rents in securing a sustainable growth trajectory. These can be secured across sectors, including in services and agriculture. He moves away from a narrow focus on the manufacturing sector as a driver of sustainable growth and income. This is because productive sector polices must adapt to the type of GVC within which producers trade. A distinction is made between two major types of GVCs and their specific policy requirements. In vertically fragmented and specialised value chains, the country must deepen its capabilities in order to transition to new ones. In additive chains, there is a need for systematic development of linkages between production nodes and between sectors.

Taglioni, Winkler and Engel emphasise how countries that understand the opportunities GVCs offer and that adopt appropriate policies to mitigate some of the risks associated are more likely to boost employment and productivity. Because flows of goods, services, people, ideas and capital are interdependent, their contribution to upgrading in GVCs depends on how the process has been managed. The imperatives for improved management of GVC engagement and the process of technological development unleashed are underscored by findings that suggest that, while more GVC engagement may create more net jobs, there may also be lower job intensity.

Razzaque and Keane emphasise concerns regarding the development of firms' technological capabilities and the achievement of social and economic upgrading processes over time through GVC engagement. Drawing attention to value chain governance and power dynamics, they note that all governments are grappling with the balance between state and business interests and the appropriate alignment of incentive structures. Competitive incentive schemes to attract GVCs can undermine economic and social objectives in the longer term. In some cases, a focus on trade facilitation measures for both imports and exports is undoubtedly beneficial. However, an alternative policy narrative is required, focusing on trade costs and capabilities, to induce inclusive and sustainable GVC participation. Small state support measures may be necessary. Moreover, greater attention should be paid to value chain development led by trade in services in countries with excessive trading costs.

Finally, the growth facilitation framework described by **Xu** describes how the transformation of latent comparative advantages into competitive advantages entails policy-makers proactively deploying effective industrial policies in collaboration with the private sector to overcome first mover and coordination problems during the process of industrial upgrading. While the popular perception that most industrial policies fail miserably has tempted us into saying 'no' to all kinds of such policies, a more constructive approach is to delve deeper into comparative studies of both successes and failures in an effort to learn and unveil new insights.

Concluding Remarks

All of the chapters in this publication are intended to draw the reader's attention to developments at the macro level that are likely to influence future fragmentation processes and the possible trajectory of the GVC mechanism in the future. They provide for a more careful examination of GVCs at the sectoral level, covering manufacturing, services and commodity trade.

Given that the overwhelming majority of the 52 Commonwealth member countries are small states, and around one fifth are least developed countries, understanding how dynamics are likely to unfold at the sectoral level is critical to encouraging more gainful GVC participation, which requires fit for purpose twenty-first century trade support measures.

All of the case studies included in this publication demonstrate how, on the one hand, trade has become fragmented and organised within GVCs, but also more co-ordinated by firms. Each of the case studies highlights new issues related to changes in business models and the emergence of tiers of suppliers. These include contractual issues, effective competition management and the process of technological innovation and adaptation.

In order to overcome some of the perennial challenges associated with achieving conventional upgrading processes in view of these changing dynamics and, within the context of meeting the SDGs by 2030, many of the sectoral case studies reach similar conclusions. These include an emphasis on developing technological capabilities, overcoming information asymmetries, strengthening the interaction between GVC engagement and institutional development.

Because the transformation of global production through firms' internationalisation strategies has fundamentally altered the conventional profit–investment nexus, it is incumbent on policy makers to pay closer attention to the institutional context within which firms trade and interact. These interactions—between public and private sector actors—must be contextualised as part of the processes of technological advancement and societal learning within a broader innovation system. In order to facilitate these processes, trade governance structures have to adapt.

Although not exhaustive, some of the policy recommendation arising from this publication include:

- **Addressing the barriers to services trade**: enhancing connectivity
- **Upgrading trade governance frameworks**: enabling knowledge transfers
- **Securing business integrity**: creating and capturing greater value

Given that the ability to transmit tacit knowledge through Commonwealth trade, finance and investment networks in view of our common language and institutions is inherent in the demonstrable effect of the "Commonwealth advantage" it suggests that the translation of already known best practice into transferrable and non-tacit forms through the sharing of toolkits and frameworks could further enhance the gains from closer collaboration. The necessity of doing so is heightened in view of the advancement of the Sustainable Development Goals.

Notes

1 These findings are based on analysis of Eora-MRIO data included in a forthcoming Commonwealth Secretariat GVC Handbook for the Caribbean and Pacific (July 2017) and, finally, a background paper prepared by Mendez-Parra (2016).

2 *Ibid.*

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