Chapter 18

Delivering Inclusive Global Value Chains

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Abstract[1]

This chapter evaluates the discourse regarding entry into and participation in global value chains (GVCs) for developing Commonwealth and francophone countries. It critically reviews conventional policy prescriptions – import liberalisation and improved trade facilitation – intended to bolster entry into and participation in GVCs. Several conditions are identified as compromising the ability of many developing Commonwealth and francophone countries to fully integrate into GVCs, even if they followed these policies. This is because trade costs and geographical distance from the dominant hubs of global economic activity still exert major influences on participation. Taking into account also the low and declining proportions of value added at entry-level stages of production, the suitability of a global GVC integration agenda in the absence of effective global economic governance structures is questionable. In addition to receiving disproportionately low shares of the gains of actual value added, many developing country members face major challenges in relation to funding, as well as in negotiating upgrading processes with lead firms, who may not wish to relinquish particular economic rents. In this context, entry into and upgrading within regional value chains may be more aligned with trade and development objectives, with a focus on adding value rather than trading it.

18.1 Introduction

Fundamental changes are taking place in global trade. The traditional predominant notion of an entire production process being undertaken by one firm, in one country, is being replaced by value chain-led trade. It involves the cross-border fragmentation of production processes, which entails specialisation in a narrower range of tasks by firms. Given the limited productive capacity of many developing countries, integrating with global value chains (GVCs) may provide new trade opportunities for local firms to gain access to new markets through specialising in a single task. By becoming part of an international production network, attracting foreign direct investment (FDI) and accessing technological know-how in more dynamic export sectors may be more achievable. Given the nature of the tasks involved, GVCs can assist in creating employment-intensive exporting activities, thus helping to achieve the 'golden nexus' of trade, growth and job creation.

Despite the potential of GVCs, however, the growing body of evidence on the nature and impact of GVC participation is mixed. Many poor, small and vulnerable developing countries, including members of the Commonwealth and the Francophonie (CF) have achieved rather limited GVC participation in more dynamic types of trade to date. In other cases, evidence of the beneficial effects of GVC participation continues to be subject to scrutiny.

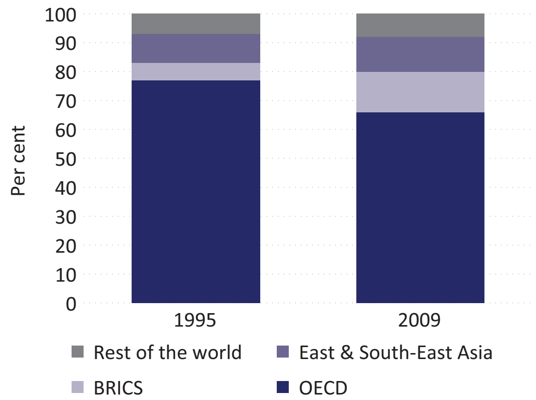
There is a proliferation of studies and analyses that consider specific policy measures to promote developing countries' participation in GVCs. While a consensus on these policy prescriptions appears to exist, in our view the implications arising from certain factors critical for delivering inclusive GVCs have not received adequate attention in the current policy discourse. This chapter highlights three areas that deserve further consideration by policy-makers in order to more effectively deliver inclusive GVCs: the inherent structural characteristics of groups of countries that competitively disadvantage participation in certain types of GVCs; the fragmented nature of global governance mechanisms, combined with fragmented production, which can undermine potential developmental gains; and the potential effects of the emerging global trade architecture on future GVC participation.

18.2 Global value-chain participation and measures to promote it

Since the early 1990s, the world export-to-GDP ratio has increased from 19 per cent to 31 per cent.[2] This growth in export intensity is partly attributable to the intensification of GVCs. The huge significance of trade in intermediate inputs, estimated to now comprise at least two-thirds of all global trade (OECD 2013), is testimony to this.

However, despite these trends there is strong evidence of highly concentrated GVC participation. It is estimated from OECD-WTO data that almost 92 per cent of the total value added created by GVCs is due collectively to members of the Organisation for Economic Co-operation and Development (OECD), the BRICS countries (Brazil, Russia, India, China and South Africa) and a few Asian nations (Figure 18.1). Measures using a different database, – the UNCTAD (United Nations Conference on Trade and Development) Eora database, as shown in Figure 18.2 – also suggest that global trade remains concentrated in what have been

Figure 18.1 Value-added trade is highly concentrated

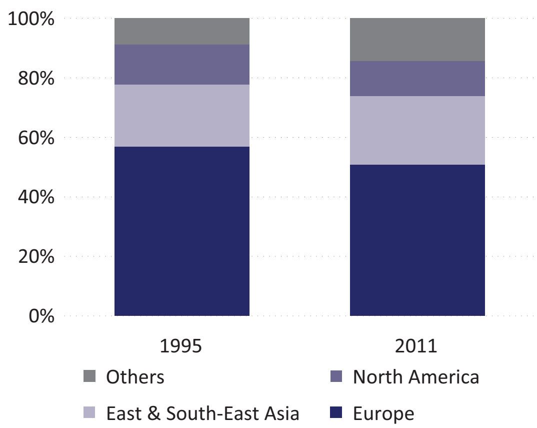


Source: Information as provided in Banga (2013) using the OECD-WTO TiVA database.

dubbed 'Factory Europe', 'Factory North America' and 'Factory Asia' (Baldwin 2011).

Although limited, there is evidence that some least developed countries (LDCs) and African countries are beginning to participate in GVCs. 'Transformed exports', including manufactures, semi-manufactures and processed primary products, now include LDC exports (ITC 2013). Africa's GVC integration in primary products is found to be increasing (AfDB 2014). However, given Africa's overall overwhelming

Figure 18.2 Europe, North America and East Asia are three major dominant regions in value-added trade



Source: UNCTAD-EORA GVC database.

economic dependence on primary commodity exports, the actual extent and nature of GVC participation is not clear. Currently, very little is known about small states' participation in GVCs and this may reflect limited evidence on services GVCs to date.

How countries participate in GVCs and where they are located within GVCs matters. Countries specialising in pre-manufacturing (e.g. R&D, standardisation, design) and post-manufacturing (e.g. logistics, marketing, brand development) activities are able to capture more value in GVCs than countries that specialise in the manufacturing of the products. The value captured by these types of services in GVCs may be considerably more than that attained from manufacturing activities.

It is generally recognised that a large majority of LDCs, small states and sub-Saharan African (SSA) countries have failed to add more value by processing their primary exports and moving up the GVCs within which they specialise. It has been argued that participating in the lower end of a GVC can be counterproductive, and may lead to a 'hollowing-out' of the manufacturing sector. Some commodity exporters may become trapped in captive value chains (Nissanke and Mavrotas 2010; Keane 2012). Developing countries may become stuck exporting low value-added items with lower gains accruing over time (Banga 2013). This disadvantageous process is also known as 'immiserising growth' (Kaplinsky 2005) – a phenomenon recognised in the case-study GVC literature of the 1990s, but ignored by the current GVC discourse.

18.3 Current policy prescriptions

In view of the new findings from input–output measures of GVC participation, a number of recent studies discuss options for more effective integration into GVCs. The typical policy considerations include import liberalisation and improved trade facilitation measures to reduce costs of imported inputs, addressing non-tariff barriers, improving the investment climate, investing in infrastructure development and linking GVCs to industrial development policies. These are of course important issues for promoting competitiveness and inducing trade responses in developing countries.

However, overcoming all exclusionary barriers to effective GVC participation within the same set of policy prescriptions is simply unrealistic. Moreover, there is a need to more carefully distinguish between interventions designed to, on the one hand, assist small and medium-sized enterprises (SMEs) in entering into GVCs and new relationships with lead firms and, on the other, assist countries in beginning GVC participation through inviting FDI and the relocation of production units from abroad.

There are inherent structural characteristics that can result in the systemic exclusion of some countries from GVCs, given the competitiveness effects of economic geography. Even when countries are integrated with GVCs, they might not be participating in a gainful way, in part because of a failure to align value-chain governance with developmental objectives, nationally as well as globally. Much of the current GVC literature, and its resultant policy implications, is reminiscent of the 1990s liberalisation agenda. Although understanding of the complex relationship between trade, growth and the achievement of economic structural transformation has improved in recent years, these lessons do not seem to have been heeded. Finally, the evolving global-trade architecture arising from the emergence of mega-regionals and the advent of developing countries as serious players in global trade are likely to be determining factors in future GVC participation. The resultant implications of these issues must be actively considered in the context of promoting inclusive, development-oriented GVCs.

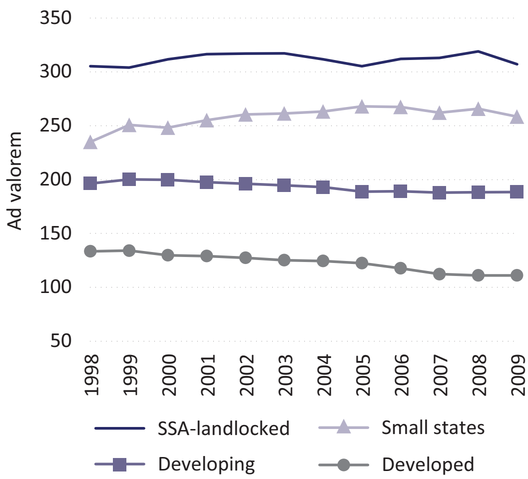
18.4 Economic geography and value-chain trade

A large number of CF countries suffer from the small size of their domestic markets in conjunction with their unfavourable geographical locations, at very long distances from the global centres of commercial activities. This inflicts serious disadvantages in terms of excessive trade costs. This cost disadvantage must be considered in the context of the low proportions of value added available at the entry-level stages of GVC participation. Firms and production units in these countries are mostly SMEs with limited productive capacity.

18.4.1 Evidence of trade-cost disadvantages

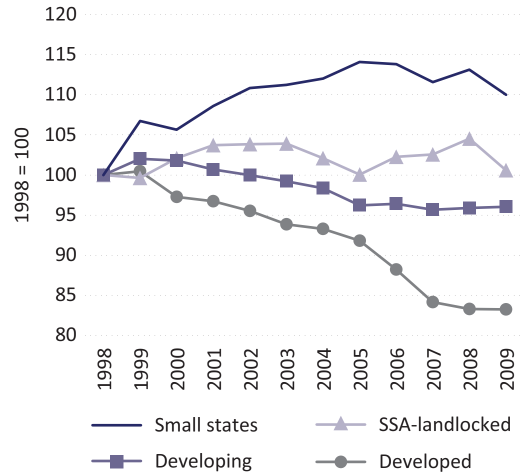
Analysis of data from a pioneering World Bank-UNESCAP (UN Economic and Social Commission for Asia and the Pacific) project confirms the severe competitive cost disadvantages faced by many landlocked SSA countries and small states (Figure 18.3). Measured in *ad valorem* equivalent terms,

Figure 18.3 Trade costs are much higher for small states and landlocked SSA countries



Source: Authors' computation using World Bank-UNESCAP data. Calculations are based on bilateral costs with 10 largest global importers.

Figure 18.4 Trade costs for small states and landlocked SSA countries, unlike those for other countries, have not been declining



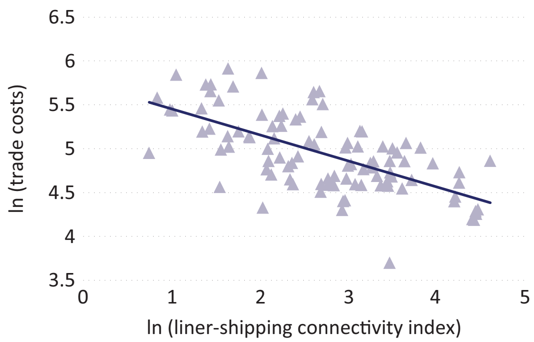
Source and note: Authors' calculation. Ad valorem equivalent trade costs are converted into index number with 1998 = 100.

the average trade costs for the group of small states and landlocked SSA countries identified are much higher than those of other country groups.[3] While developed countries have experienced considerable reductions in trade costs and developing countries show a general trend towards reductions, this is not the case for small states (Figure 18.4).

While geographical distance between bilateral trading partners exerts the largest impact on trade costs, other factors, such as liner shipping connectivity, are also shown to have an important influence (Arvis *et al.* 2013). Indeed, the liner-shipping connectivity index (a high value indicates better connectivity) and trade costs are strongly and inversely correlated (Figure 18.5). Even with improvements in shipping connectivity, unfavourable geographical location combined with small consignments may indicate limited trade gains (Figure 18.6).

These excessive costs have serious implications for trade in general and participation in GVCs in particular. A 10 percentage point increase in transport costs is found to reduce

Figure 18.5 Trade costs are negatively related to improved shipping connectivity

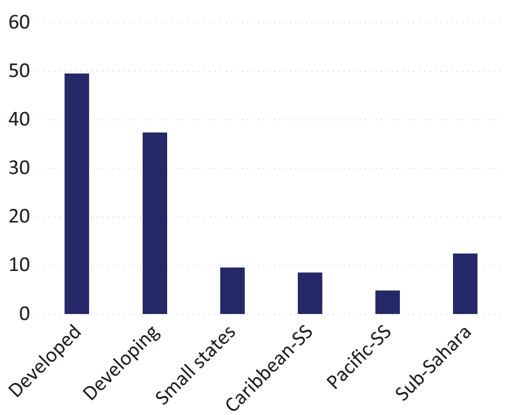


Source: Authors' illustration, with liner-shipping index data from UNCTAD and trade costs data from World Bank-UNESCAP. Log of trade costs used.

trade volumes by about 20 per cent (Limao and Venables 2001). Moreover, country *ad valorem* transport costs of 20 per cent on both final output and intermediate goods reduce domestic value added (including wages and profits) by 60 per cent when intermediate goods account for 50 per cent of costs. The implication is that because of geographical location, foreign firms might be reluctant to move or relocate their production to these countries – even when wages are low (Redding and Venables 2001).

The typical policy prescription of liberalising trade, ensuring good domestic policies and

Figure 18.6 Small states and SSA countries have much lower liner-shipping connectivity index scores



automatically attracting FDI and value chain-led trade, is therefore likely to be unhelpful in these circumstances. It has been argued that distance matters more in supply chains and, even with today's information and communications technology revolution, global production networks are likely to remain concentrated in low-wage nations that are near, or even contiguous with, high-technology nations (Baldwin 2011). This reality poses a major challenge to the current GVC narrative. The fragmentation process of the future will be different from that of the past and is likely to be at a much lower level of disaggregation. This is something policy-makers must be more sensitive to. Others point out that the fragmentation process of services has hardly begun yet.[4] These future developments are likely to be of particular interest to many Commonwealth small states.

18.5 Value creation and distribution: effective governance of global value chains

Longstanding concerns of CF developing members regarding the highly asymmetric distribution of value within GVCs remain unaddressed. Effective value-chain governance requires the alignment of incentive structures for firms taking into account public policy and developmental objectives. There are risks of advancing a GVC integration agenda without effective global economic governance structures.

As GVCs have been fragmented across countries, they have also become more tightly co-ordinated by lead firms; this process is reflected in a movement from arm's-length relations towards closer inter- and intra-firm relations.[5] New estimates by UNCTAD (2013) suggest that 80 per cent of global trade occurs within networks co-ordinated by multinational enterprises (MNEs) and that around 30 per cent of this is in the form of intra-firm trade.

Developing countries may have begun to trade more, and more recently have increased trade in value added, but they may not necessarily be gaining more from this trade (UNCTAD 2002, 2013). This is because lower value-added activities are either outsourced or offshored by lead firms, while higher value-added activities are retained. Manufacturing stages of production have simply become less valuable over time for producers locked into this stage of production.[6] We summarise some of the relevant findings from the case study-based GVC literature below:

- **Coffee:** it is estimated that the farm-gate price of coffee, which is subsequently divided up among traders, producers and labourers, equates to around 10 per cent of the final retail price of coffee sold on supermarket shelves. This is compared with the 22 per cent that accrues directly to retailers, or 51 per cent if prepared own-brand coffee is marketed by the retailers (Fitter and Kaplinsky 2001).[7] Because of the collapse of the International Coffee Agreement in 1989, the liberalisation of coffee-marketing systems and the entrance of new actors trading more virtually, local producers and traders in coffee-exporting countries are bearing the full brunt of low and increasingly unstable coffee prices.[8] Considering a major coffee-exporting SSA country, Uganda, where 90 per cent of the population is involved in subsistence farming, with around 1.5 million households associated with coffee-related activities, there is evidence to suggest that Uganda trades within a captive value chain.[9]
- **Garments:** in terms of the distribution of value added within the apparel sector, 70 per cent of the retail price is retained by lead firms in the United States, while manufacturing activities, including sourcing of raw materials from third countries and the shipping costs involved, account for the remaining 30 per cent.[10] In the process, factory workers in an LDC such as Bangladesh, with an official minimum monthly wage of US$68, receive just 1 per cent of the total value of the finished product. The sector is a major employer of women.
- **Horticulture:** in terms of value distribution for the average firm, it is estimated by Hortiwise (2012) that Kenyan growers receive 15 per cent (US$0.11) of the total retail value, compared with the 64 per cent (US$0.74) retained by retailers. This is around the same level reported by Dolan and Humphrey (2000) for the horticulture sector, and by Kaplan and Kaplinsky (1998) for the deciduous canned fruit sector. Like the garment sector in Asia, the horticulture sector in Africa is a major employer of women.

It is fair to say that many CF developing countries remain trapped in low value-added segments of GVCs, and highly asymmetric power relations between chain actors are not conducive to advancing desired social and developmental objectives. As argued by Kasente (2012), there is a great need for gender equality issues to be integrated into all stages of coffee production and marketing – referred to as 'value chains' – if women are to realise prosperity from their labour and move up the value chain as active participants and decision-makers. Buyers and lead firms are becoming more demanding, but they do not always provide support or transfer knowledge and capabilities (Pietrobelli 2008), or offer higher price margins to incentivise economic and social upgrading. Even leaving aside the issue of distribution, the low proportions of value added now available in the entry-level stages of GVCs further emphasise the formidable challenges faced by CF members with amplified trade costs due to economic geography considerations.

Based on the available evidence from GVC case-study analysis, it is becoming clear that increasing and sustaining value addition and upgrading processes over time may not be possible unless public and private governance structures and public/private actor incentive structures are aligned. This obviously becomes much more challenging in the context of globalised firms operating without effective global governance structures.

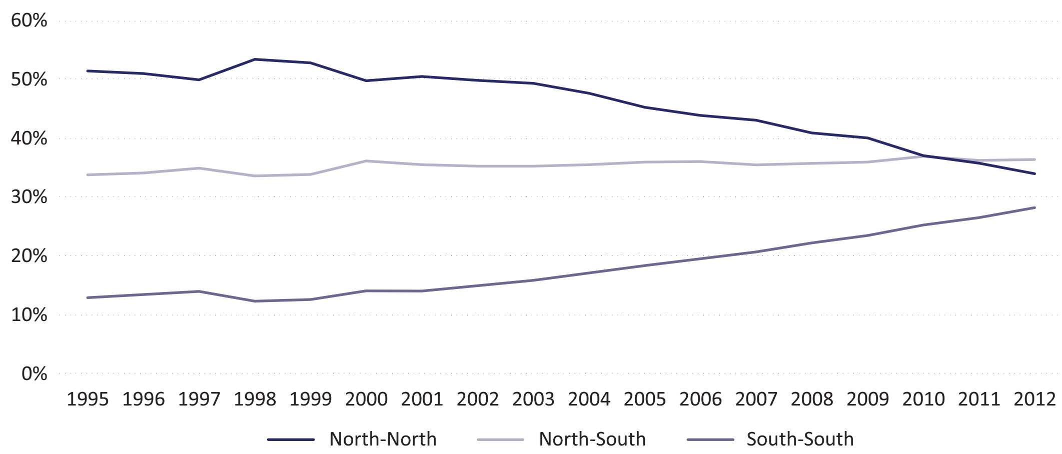
Simply reducing trade costs at the border (e.g. in the way of improved trade facilitation) is unlikely to alter the existing highly unequal distribution of value added. Cutting trade costs across the board could actually result in increased competition among developing countries in a 'race to the bottom' and engagement with the low value-added components of supply chains. It has been suggested that whether or not to actively promote GVCs is a strategic choice for policy-makers (OECD-WTO-UNCTAD 2013). However, the viability of existing global governance in managing value chains has not been given due consideration to date. Given the very real forces of convergence and divergence in operation within the global economy, there are concerns that the ascendency of GVCs might actually accentuate these processes (Keane and Basnett 2015).

18.6 The rise of developing countries in global trade: new demand drivers

The rising significance of developing countries within global trade is another factor that is likely to exert a strong future influence on GVC development. Almost half of global merchandise exports and about 40 per cent of world GDP are now attributable to developing countries. An important feature of this development is the rapidly expanding trade between developing countries: the average annual growth of South–South trade since 2000 has been 17 per cent, compared with world trade growth rate of 10 per cent. This has caused the relative significance of trade between developed countries (i.e. North–North trade) to decline from about 53 per cent in the late-1990s to just 34 per cent in 2012 (Figure 18.7).

Trade with fast-growing developing countries offers new opportunities for specialisation, efficiency gains, investment and export-market diversification. Some of the BRICS members, particularly China and India, now provide improved market access to LDCs. They have also become important sources of technical and financial assistance. Nevertheless, there are concerns that increased South–South trade

Figure 18.7 The relative significance of South–South trade is rising rapidly



Source: Razzaque and Gosset (2014).

has bypassed a large number of SSA countries and small states. The nature of trade patterns with emerging economies indicates that SSA countries and small states predominantly export primary commodities and largely import manufactured items. There is apprehension about this nature of specialisation within South–South trade.

However, the growing significance of developing countries within global-trading flows offers new opportunities for forming regional supply chains. It is widely recognised that most production networks and supply chains are regional in nature. For example, studies, including those undertaken by the Commonwealth Secretariat and UNCTAD, have identified the potential for developing regional supply chains in SSA and South Asia in such sectors as textiles and clothing, leather and leather products, and agroprocessing. As much as 40 per cent of intra-SSA trade takes place in manufacturing, indicating significant scope for developing regional production networks.

Another important aspect of the rise of developing countries is empirical evidence suggesting that new markets and growth centres are closely related to growth in neighbouring countries (e.g. Redding and Venables 2001; Moore 2015b). The growth of such countries as Nigeria and South Africa is thus likely to have a positive impact for neighbouring countries in SSA (Moore 2015b). Delivering inclusive regional value chains may therefore be a more achievable objective than the pursuit of GVCs, in some cases. For small economies and firms, regional value chains linking neighbouring countries may offer more sustainable growth opportunities and more manageable scales than global markets (Gereffi and Luo 2014).

18.7 Charting the way forward and concluding remarks

As the discussion in this chapter has made clear, advancing an inclusive GVC agenda faces a number of formidable challenges. In this regard, there is a need for a more nuanced approach and greater consideration of the unique development challenges faced by CF states. Ensuring more inclusive GVC participation requires greater consideration of the heterogeneity of capacity-constrained CF states. The development of a more appropriate global-trade support architecture must be considered in the context of a rapidly changing global-trading landscape.

18.7.1 Adapting to the new global-trading landscape

The rise of the global South offers opportunities for developing regional supply chains, as a result of the emergence of new growth poles and hubs of commercial activities. While the current international specialisation in which SSA and small states largely supply primary commodities to emerging Southern partners is of concern, there is some evidence of the potential to develop regional supply chains involving the manufacturing and agroprocessing sectors. Delivering inclusive regional value chains may be a more achievable objective than the pursuit of GVCs, in some cases, and deserves more attention (Kamau 2009; Brandt and Thun 2010; Navas-Alemán 2011; UNCTAD 2013).

18.7.2 Delivering more targeted aid-for-trade

The aid-for-trade support initiative has assisted many developing countries with their enhanced regional integration and improved trade facilitation efforts. However, the existing support mechanism needs to duly recognise the special and unique development challenges faced by small states. While there is evidence that aid-for-trade is effective in promoting trade facilitation, its impact on productive capacity (i.e. in generating export response from tradable sectors) is not clear.[11] Given the distinct characteristics of small states, support measures that are required to address similar challenges elsewhere may not be suitable for them. For example, improving regional connectivity by building cross-border road and rail networks invariably has limited relevance for small island states. The following points should be noted:

- A narrow focus on trade facilitation measures, although necessary, will not be sufficient to induce more inclusive GVC development. A strong case can be made for small state-specific support measures in addition to innovative changes to existing mechanisms.
- The potential for value-chain development led by trade in services needs to be explored for countries with excessive trading costs.

18.7.3 Effectively governing global value chains

The governance of GVCs, including the relationships between lead firms and local suppliers, is an area that needs to be better understood in order to secure more inclusive GVC development; this encompasses the inclusion of firms in higher value-added activities within GVCs, as well as increasing domestic value added from existing GVC participation. The current pattern of highly unequal distribution of value added along GVCs, combined with declining value added for particular functions, is not conducive to the design of more inclusive approaches. For example:

- there are concerns regarding the development of local firms' technological capabilities and the achievement of social and economic upgrading processes over time, and the empirical evidence is mixed and highly context specific;[12]
- all governments are grappling with the balance between state and business interests and the appropriate alignment of incentive structures;
- unless aid-for-trade is better targeted at increasing bargaining power within GVCs, there are concerns that potential benefits may flow to those with power within the chain, not the intended beneficiaries (Mayer and Milberg 2013); and
- in the absence of effective global governance mechanisms, there are concerns about the creation of competitive incentive schemes, which can undermine, rather than promote, social-upgrading processes.

Notes

1 This chapter was prepared as part of the 2015 annual Commonwealth and Francophonie dialogue with the G20, convened by the Secretariats of the Commonwealth and La Francophonie, together with Turkey as G20 President and Chair of the G20 Development Working Group. It was presented on 14 April 2015 at the International Monetary Fund, Washington, DC.

2 Authors' estimates based on UNCTADstat data.

3 This chapter uses the Commonwealth Secretariat definition of small states. These are defined as independent states with populations of up to 1.5 million, with a few exceptions. This definition follows the World Bank small states classification, with some exclusions of countries that are classified as 'developed' by UNCTAD. This sample includes 49 countries, 31 of which are Commonwealth members.

4 Lanz and Maurer (2015) also point out that advances in statistics by enterprise characteristics and by mode of supply (i.e. taking into account the movement of labour and capital) are required in order to better understand trends.

5 For example, UNCTAD (2013) draws attention to equity and non-equity modes of international production.

6 Kraemer *et al.* (2011) found that for every US$299 iPod sold in the USA, the value captured from these products through assembly in China was around US$10, i.e. 3.3 per cent of the total value of the final product.

7 See also Gibbon and Ponte (2005) and Oxfam (2005).

8 According to Newman (2009), international coffee markets have become financialised, with firms dealing in physical commodities as well as other financial services and hence coming to resemble financial holding companies.

9 Keane (2012, 2014) argues that the coffee GVC in Uganda now resembles a captive value chain, given low supplier competence in the face of increasingly complex transactions and a transactional dependence on lead firms.

10 Report by Moongate Associates, available at: http://tppapparelcoalition.org/

uploads/021313_Moongate_Assoc_Global_Value_Chain_Report.pdf (accessed 20 March 2015).

11 For example, see Commonwealth Secretariat-supported analytical studies on aid-for-trade such as Razzaque and Te Velde (2013).

12 Barrientos *et al.* (2010) developed a conceptual framework to analyse economic and social upgrading across comparative GVC studies, as part of their work under the research consortium Capturing the Gains (http://www.capturingthegains.org/about/).

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