Chapter 3

Trade and Investment Policies: Shaping the Future of GVCs

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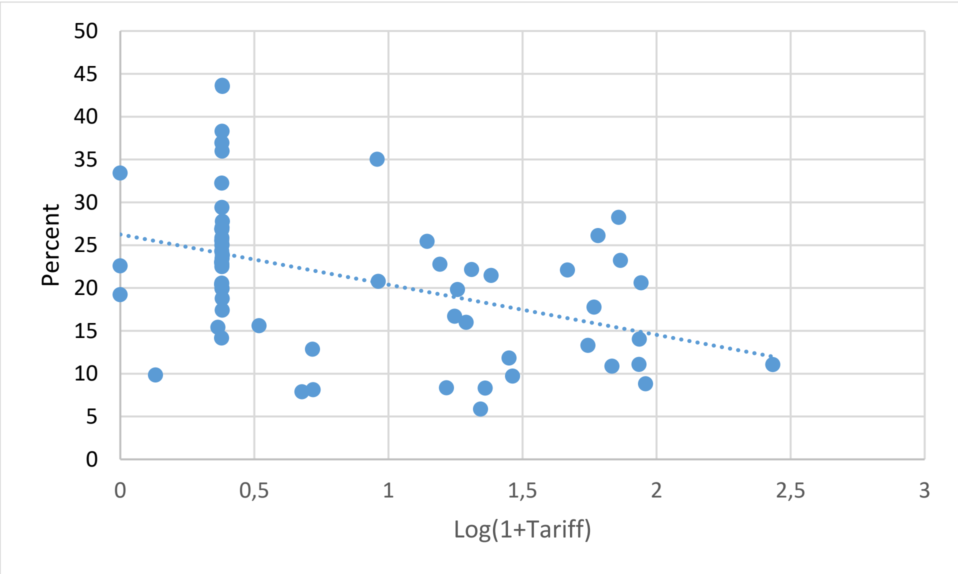
CHAPTER 3

TRADE AND INVESTMENT POLICIES: SHAPING THE FUTURE OF GVCS

1. An Enabling Environment for GVCs

The GVC business model emerged primarily in the 1990s and 2000s, when tariffs were at historical lows in many countries. Over recent decades, Asia has been a relatively liberal region by world standards, even though significant impediments to trade remain in the form of inefficient or ineffective regulatory measures, and other non-tariff measures (NTMs). Nonetheless, the role of relatively open trade and investment policies in facilitating the growth of GVCs is undeniable. Figure 15 makes the point in a simple way, by showing a negative correlation between country-level average applied tariffs and the aggregate proportion of backward GVC linkages. The negative line of best fit suggests that lower tariffs are indeed associated with stronger backward GVC linkages.

Figure 15: Correlation between Applied Tariffs and Backward GVC Linkages



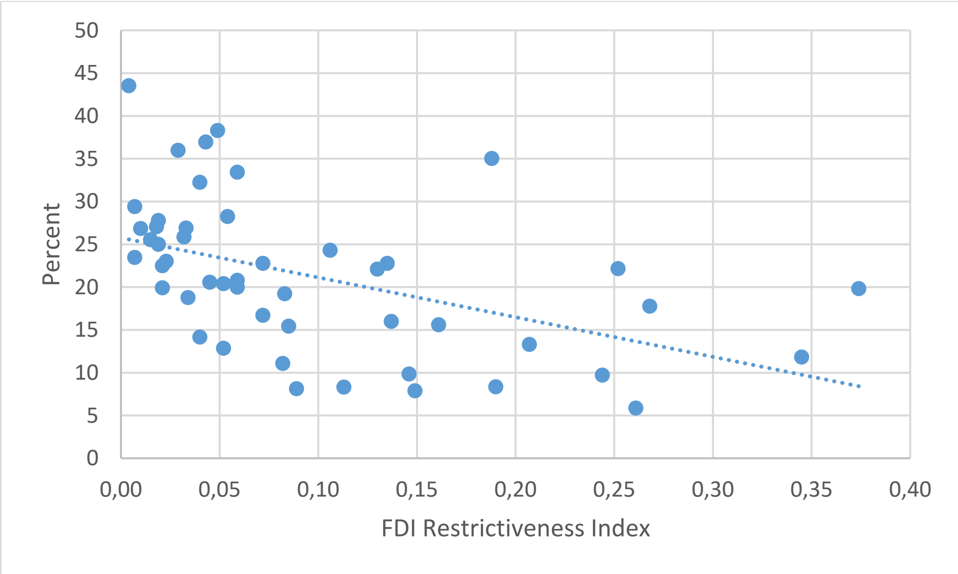
GVC = global value chain.
Source: Author's calculations.

But in the modern era, trade policy is about much more than tariffs. Trade economists typically talk about 'trade costs' as the full range of factors that drive a wedge between producer prices in the exporting country and consumer prices in the importing country (Anderson and van Wincoop, 2004). From the broad scope of this definition, it is immediately clear that a wide range of other policies also determines the ability of firms to contest foreign markets, or equivalently, to source intermediate inputs from foreign suppliers. In the GVC context, there is good evidence, for example, that improving trade facilitation can increase backward and forward linkages across countries: Shepherd (Forthcoming c) shows that global implementation of the World Trade Organization (WTO) Trade

Facilitation Agreement could lead to increased production sharing by an amount equivalent to 3 years' worth of average global growth in GVC integration from 2000 to 2019.

There is no comprehensive listing of policies that can promote GVC linkages. But by analogy with the tariff case, it would be important to take account of restrictions on FDI also. To do that, Figure 16 shows the association between the OECD's FDI Regulatory Restrictiveness Index and backward GVC participation. Again, the line of best fit is negative, which means that a more restrictive regulatory regime governing FDI is associated with a lower degree of GVC integration.

Figure 16: Correlation between FDI Restrictiveness and Backward GVC Linkages



FDI = foreign direct investment, GVC = global value chain.
Source: Author's calculations.

Beyond policies affecting FDI and those affecting trade directly, it is likely that broader considerations concerning the business environment also play a role in structuring GVC interactions. This linkage is particularly important where GVC interactions are not exclusively at arm's length, but also involve relationship-specific investment. Clearly, an investor needs to be assured that the investment will be protected by basic legal instruments. Contracts need to be enforceable reasonably easily and with certainty. Dealings with the government need to be transparent and predictable. An econometric study in OECD (2016) confirmed the importance of these kinds of factors, but again, the list is neither definitive nor exhaustive. It is intended to give a flavour of the types of policies that can be important from the point of view of facilitating GVC interactions.

Of course, GVCs are not only economic entities. They also have implications in other spheres, such as social and environmental conditions. In some countries, the GVC business model has been challenged because it is thought to exacerbate environmental problems, and put stress on social objectives like managing inequality. So, in addition to ensuring openness to trade and investment flows, it will be important to continue to work on developing social safety nets and redistribution mechanisms. Doing so will help ensure continued support for this development model in a political economy sense. The key challenge for low- and middle-income countries is to learn from successful examples of rapid income growth and sustained poverty reduction that have made strategic use of GVC integration in the service of broader development objectives. Viet Nam is perhaps the best case in point: it has engaged rapidly with GVCs in a broadening list of sectors, and has succeeded in reducing poverty and moving a significant number of people into the global middle class (World Bank, 2018). Of course, backsliding on these advances is a real risk given the size of the economic shock associated with the COVID-19 pandemic. But there is nothing to suggest that recovery will be aided by restricting movements of goods, services, and capital across borders; rather, it is likely that supporting an open, rules-based trading system remains a key economic policy objective for smaller low- and middle-income countries in particular, as it provides them with a source of external demand to aid in the recovery effort.

It is also important to take notice of the large literature using micro-data, which shows that firms that engage with the international economy, including through GVC linkages, tend to be larger and more productive than firms that focus on the domestic market only, and that they also play higher wages to their workers than domestically focused firms (e.g. Brambilla, Depetris Chauvin, and Porto (2017)). There is also a recent literature showing that internationally engaged firms in developing countries tend to employ more women than firms that focus on the domestic market only (e.g. Shepherd (2018); Rocha and Winkler (2019)). Results like these suggest that international engagement can have benefits for workers through increased employment rates and higher wages, which in turn can translate into gains in human well-being and enhanced capability.

2. Reshoring: A Way of Promoting Resilience?

An additional issue that has arisen during the COVID-19 pandemic relates to the fragility of GVCs.[2] Anecdotally, important goods experienced shortages in the early days of the pandemic, with examples such as personal protective equipment and hand sanitiser standing out.[3] To some extent, the shock was amplified by restrictive trade policies, whereby producing countries restricted exports (Park, 2020). The debate is all the more salient with the need to distribute vaccines as widely and quickly as possible, but with production reliant on geographically dispersed facilities. Given this context, concerns over ensuring the continuity of the supply of critical goods has been transformed into a discussion about the merits of 'reshoring', or the shortening of GVCs to emphasize a greater amount of local content.

The reshoring debate gives rise to two important empirical questions, for which there is as yet no conclusive answer in the literature. First, how easily can the spread of GVCs be undone through the imposition of unilateral trade policies such as tariffs? Second, how desirable is it from a supply chain resilience point of view to use such measures to bring about a substantial reshoring of some activities currently undertaken through GVCs?

Shepherd (Forthcoming a) uses a global trade model with GVCs to provide an answer to the first question. The unilateral US tariffs, to which China responded in kind, are very high relative to baseline levels, up to 25% *ad valorem* in some cases. The trade policy shock is therefore very large. But while there is some unravelling of GVC linkages, there is by no means a wholesale disintegration of the model – at least in terms of the proportion of gross exports that is accounted for by GVC trade. While

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[2] This section draws on a policy brief prepared by the author for the United Nations Development Programme (forthcoming).

[3] Association for Professionals in Infection Control and Epidemiology (2020).

GVC trade shrinks substantially in absolute terms, so too do other kinds of trade, so that the change in terms of proportions is much smaller. Shepherd (Forthcoming a) estimates that the tariff shock equates to 3–5 years' worth of undoing of GVC growth at the previous trend rate in the affected countries. So the effect is significant, but given the very large shock involved, it shows that 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.

From the perspective of the desirability of reshoring, OECD (2020) used its own global trade model to look at the impacts of shifting to more domestically focused supply chains. They found that, far from decreasing volatility, this step increases it. The result should not be surprising given that most economic shocks are not perfectly correlated across countries, so diversifying suppliers allows countries to effectively diversify risk. 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.

Putting these two results together suggests that using trade policy to promote reshoring may be both ineffective and highly inefficient. But despite this, the issue of supply chain resilience more broadly is an important one, in particular when GVCs are used to produce necessities from a public health or safety perspective. Indeed, there is evidence that the private sector is already concerned with improving resilience in light of the vulnerabilities exposed by the COVID-19 pandemic. But the focus is on diversification, supplier redundancy, and technology, rather than large-scale reshoring (McKinsey Global Institute, 2020). While policy intervention may be required at some point, the case for a broad-based policy response appears weak while the private sector is already taking steps that may go at least some way towards remedying the problem. In time, 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. In any case, any intervention will need to balance the efficiency advantages of GVC production against any possible social objectives that are not fully fulfilled.

Experience with past shocks is a useful guide to how the immediate future may involve some redesign of GVCs, without wholesale changes to the business model. The floods in Thailand in 2011 led to a global shortage of some electronics components, particularly hard drives. But technological change combined with private sector reassessment of risk has led to an effective diversification of suppliers, with countries specialised in alternative technologies such as solid state drives effectively assuming part of the global market (Sriring, 2016). Despite the strategic importance of the sector and the size of the shock, public policy changes generally did not follow.

From the perspective of countries in East and Southeast Asia, a number of issues emerge from this discussion of reshoring. While there is some policy-related risk that large markets like the US may seek to increase the proportion of DVA in production, it has declined substantially with the new administration, and there is a strong case to make that such moves would be both ineffective and highly inefficient. Nonetheless, they would have the potential to disrupt trade and investment flows in East and Southeast Asia, given the role of countries in the region as suppliers within GVCs that ultimately export final goods and services to other markets, including the US. However, the risk at this point is deserving of vigilance and sustained criticism within multilateral forums, but should not be seen as an imminent threat to GVC development in the region.

The bigger risk to economies in East and Southeast Asia, which is not unrelated, is that recovery in the large, high-income markets of Europe and the US is slower than expected. The region has generally performed very well in terms of responding to the COVID-19 pandemic, but a sluggish recovery overseas would both directly hamper demand growth for the region's exports, and increase the political risks stemming from distributional tensions in the high-income markets.

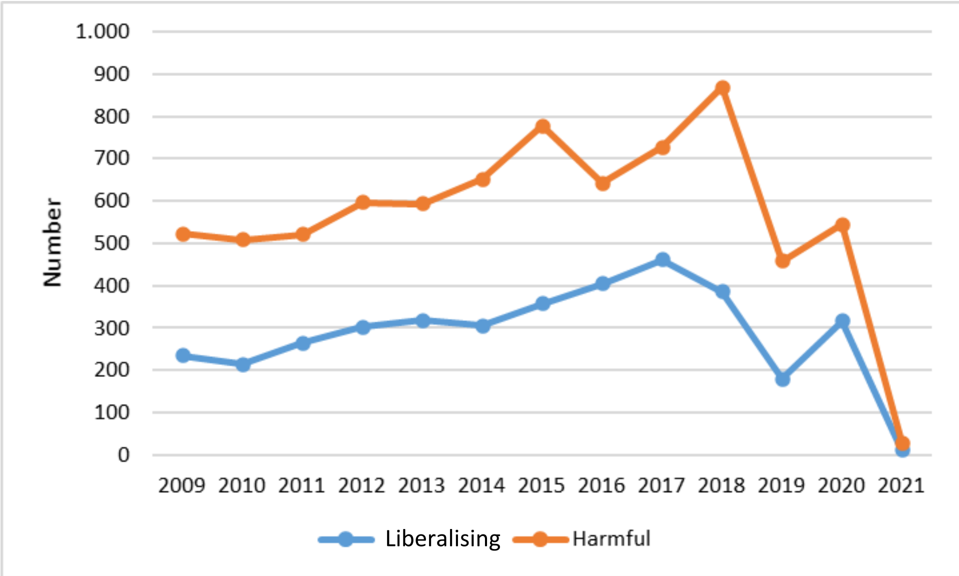
From an investment point of view, the picture is quite different. Robust social responses in Europe and the US, combined with reduced spending opportunities, have seen household savings increase substantially. As such, those funds will be available for investment, including in East and Southeast Asia. However, a necessary condition for that to happen is the existence of profitable opportunities, which in turn depends on expectations of future growth. But on the investment side, there is reason for optimism, as 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. In recent years, however, there has been a noticeable move towards 'murky' trade policy measures, ranging from subsidies to various kinds of quasi-trade measures that discriminate against foreign producers, but which do not easily fall into the traditional categories analysed by trade economists.

The Global Trade Alert has been tracking trade policy interventions for more than a decade, casting the net as wide as possible in terms of the measures catalogued. Figure 17 shows the number of new interventions each year that affect ASEAN Member States, distinguishing between liberalising and harmful interventions. First, there has been a general increase in the number of interventions over time, although data for the most recent years do not fit the general trend; of course, data for 2021 are based on only a single month of data, and so are not representative. It is highly likely that the increase in interventions seen from 2019 to 2020 was due to the COVID-19 pandemic, which saw many countries turn to activist trade policy as part of their response. The second main finding is that while liberalisation and discrimination are both included in new trade policy measures, the balance is overwhelmingly in favour of harmful measures: the number is typically around double the number of liberalising measures in a year. So there is reason for concern as to the trade policy environment facing East and Southeast Asia going forward, in addition to the specific issue of reshoring discussed in the previous subsection.

Figure 17: New Trade Interventions by Year, All Countries Affecting ASEAN, Count



ASEAN = Association of Southeast Asian Nations.
Source: Global Trade Alert.

Table 1 extracts the top sectors for liberalising and harmful measures respectively, taking the total over the full sample period (2009–2021). The list immediately makes clear that the most commonly targeted sectors by both types of measures are typical GVC sectors such as motor vehicles, computers, electronics, and pharmaceuticals. The pattern is particularly striking in the case of harmful measures, which are almost exclusively focused on GVC sectors in the top 10 most targeted sectors. So while at a macro level the policy risk from extensive reshoring is likely relatively low, as argued above, the picture looks quite different at a micro level. There is good reason to be concerned about the continuation of this pattern, and what it implies for GVCs in East and Southeast Asia. While most of the measures are still in goods markets, there is increasing evidence of distortions to FDI as well. As such, these kinds of measures could be disruptive to the spread of GVCs. They may not unravel the business model substantially, or fundamentally alter its scope or extent, but they certainly have the capacity to result in sluggish growth in production sharing in the short to medium term. Combined with possible limits on demand in traditional target end-markets, the overall risk to GVC development in the region is not negligible.

Table 1: Sectoral Breakdown of Measures, 2009–2021, Count

Sector	Liberalising	Sector	Harmful
Motor vehicles, trailers, and semi-trailers; parts and accessories thereof	483	Products of iron or steel	991
Other general-purpose machinery and parts thereof	411	Other fabricated metal products	863
Other special-purpose machinery and parts thereof	406	Motor vehicles, trailers, and semi-trailers; parts and accessories thereof	853
Electric motors, generators, and transformers, and parts thereof	356	Computing machinery and parts and accessories thereof	466
Pumps, compressors, hydraulic and pneumatic power engines, and valves, and parts thereof	342	Pharmaceutical products	444
Basic organic chemicals	335	Basic iron and steel	418
Other electrical equipment and parts thereof	321	Chemical products n.e.c.	414
Chemical products n.e.c.	320	Basic organic chemicals	406
Vegetable oils	315	Electric motors, generators and transformers, and parts thereof	388
Instruments and appliances for measuring, checking, testing, navigating, and other purposes, except optical instruments; industrial process control equipment; parts and accessories thereof	312	Other general-purpose machinery and parts thereof	387

n.e.c. = not elsewhere classified.

Note: The table shows the top 10 sectors for each measure.

Source: Global Trade Alert.

Table 2 goes further into the data by categorising the type of measure involved, again focusing on those that have an effect on ASEAN Member States. Amongst liberalising measures, by far the most common measure is import tariffs, i.e. reductions in applied tariff rates. But other types of measures are also significant, such as financial grants and liberalisation of tariff rate quotas. Amongst harmful measures, the key interventions are again import tariffs (increases in applied rates), various kinds of financial and tax incentives, and limitations on public procurement. On the harmful side of the ledger, there is evidence of increased movement towards 'murky' trade policy measures, as mentioned above. In particular, the use of direct financial interventions, including through tax policy, is an area that is currently only partly regulated at the international level, through subsidy rules. Similarly, public procurement has some level of WTO regulation, but there is still clearly considerable scope for importing markets to introduce discrimination in different ways. From a GVC perspective, these types of measures are important, as they affect what was referred to above as the 'enabling environment' for the GVC business model. To function properly, GVCs need legal and commercial certainty surrounding movements of goods, services, people, ideas, and capital. These kinds of measures upset that equilibrium to some extent, so continued vigilance is warranted. To the extent that they respond to protectionist pressures in other countries, there is good reason to expect that the observed patterns may be maintained or even intensified in the short to medium term if the post-COVID-19 recovery proves slower than desired.

Table 2: Interventions by Type, 2009–2021

(number)

Type of intervention	Liberalising	Harmful
Anti-circumvention		304
Anti-dumping	1	533
Anti-subsidy		50
Capital injection and equity stakes (including bailouts)		304
Competitive devaluation		23
Consumption subsidy	1	4
Controls on commercial transactions and investment instruments	1	
Export ban	134	412
Export licensing requirement	361	489
Export quota	259	232
Export subsidy	125	409
Export tariff quota	6	2
Export tax	861	801
Export-related non-tariff measure, nes	139	75
FDI: Entry and ownership rule	46	21
FDI: Financial incentive	3	
FDI: Treatment and operations, nes	6	17
Financial assistance in foreign market	7	361
Financial grant	5,262	8,906
Import ban	163	226
Import incentive	92	34
Import licensing requirement	703	580
Import monitoring	8	29
Import quota	279	130

Type of intervention	Liberalising	Harmful
Import tariff	9,778	7,302
Import tariff quota	1,196	547
Import-related non-tariff measure, nes	371	380
In-kind grant		51
Instrument unclear		40
Intellectual property protection		1
Interest payment subsidy	7	191
Internal taxation of imports	469	175
Labour market access	796	549
Loan guarantee		411
Local labour		6
Local operations	7	104
Local sourcing	29	251
Localisation incentive		145
Other export incentive	197	304
Post-migration treatment	63	42
Price stabilisation	368	424
Production subsidy	56	237
Public procurement access	4	113
Public procurement localisation	181	4,044
Public procurement preference margin		69
Public procurement, nes		12
Safeguard	5	234
Sanitary and phytosanitary measure		6
Special safeguard		6
State aid, nes		42
State aid, unspecified		4
State loan	1	1,253
Tax or social insurance relief	109	1,733
Tax-based export incentive	177	1,107
Technical barrier to trade	1	8
Trade balancing measure		11
Trade finance	9	1,188

Type of intervention	Liberalising	Harmful
Trade payment measure	6	15

FDI = foreign direct investment, nes = not elsewhere specified.
Source: Global Trade Alert.

The overall picture that emerges from the available policy data is that GVC development in East and Southeast Asia rests on a stable foundation of trade and investment links. To the extent that there are risks, they are not primarily at a macro level: 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. As such, this development poses some risk to GVC growth and development. If the slowdown observed since 2009 is related in part to these kinds of policies, then 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.