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#### Asia-Pacific Trade and Investment Report 2015:

##### Review of recent trends and developments

##### Asia-Pacific participation in value chains: the role of trade and investment policies

### ***Summary of the Asia-Pacific Trade and Investment Report 2015***

#### **Note by the secretariat\*\***

#### *Summary*

The present document is based on the forthcoming *Asia-Pacific Trade and Investment Report 2015* (henceforth the Report), which is the main substantive document prepared for the fourth session of the Committee on Trade and Investment. The Report comprises two parts. In the first part, there is a focus on trends and developments in trade in merchandise and commercial services, foreign direct investment flows, performance in trade facilitation, and reliance on preferential policies and trade agreements from the Asia-Pacific perspective. The second part of the Report contains an analysis of the participation of Asia-Pacific economies in global and regional value chains. By observing how Asia-Pacific economies at different levels of development have integrated into supply chains at different speeds and to varying extents, we can also cast light on those policies that influence and shape value chain participation and hence influence future patterns of trade and investment. The particular features of participation in value chains also have an impact on the ability of countries to access foreign technology and build innovative capacity, which in turn influences structural change and future development options. The drafting of the Report was heavily influenced by the central tenets of the outcome document of the United Nations Conference on Sustainable Development, “The future we want”, namely the promotion of “sustained, inclusive and equitable economic growth, creating greater opportunities for all”. By summarizing the most important findings of the Report, the present document also contains items for consideration by the Committee.

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\* E/ESCAP/CTI(4)/L.1.

\*\* The late submission of the present document is due to the non-availability of 2015 data by the deadline for submission of documents to conference services.

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### **I. Introduction**

1. Global commerce today touches the lives of more people than ever before. Indeed, the internationalization of the global economy has intensified significantly during recent decades. Many services — once thought to require physical interaction and hence essentially non-tradable — can now be exchanged anywhere in the world using information and communications technology (ICT). The share of cross-border capital flows in global gross domestic product (GDP) has surged. Manufactured goods today are made using parts sourced from across the world and the assembly of products can be fragmented and dispersed among a range of locations.

2. In many ways, the developing countries in the Asia-Pacific region have been the most successful at leveraging these trends and integrating themselves into global and regional value chains. This integration has contributed to making Asia and the Pacific the single largest trading region in the world, and biggest recipient of global inward foreign direct investment (FDI). The expansion of trade and investment in the region has directly contributed to the substantial gains witnessed in poverty reduction and improved welfare.

3. Since the financial crisis of 2008, however, both global and regional growth in trade and investment has slowed significantly. As the global economy continues to face headwinds posed by one challenge after another, trade and investment flows have remained volatile and have yet to return to the pre-crisis pattern of sustained expansion. The period 2014-2015 has, thus far, exhibited continued lacklustre performance. Volumes of merchandise trade, FDI and, to a certain degree, trade in commercial services were all essentially flat. Looking forward, considerable uncertainty remains as the global economy undergoes a series of adjustments, not least from slackening growth in China.

4. A failure to return to patterns of strong trade and investment growth is of particular concern for the region's developing economies — especially those in the low-income category. Following trade-led strategies for inclusive and sustainable development will be particularly difficult in a weakened external environment. Indeed, we may be observing a “new normal” in which changing dynamics in global supply chains see trade growing at only the same rate, or more slowly than, global growth in GDP — a reversal of the pre-crisis trend. To devise an effective response to these conditions, it is imperative to more fully understand the dynamics behind the region's recent trade and investment performance. This involves disentangling the cyclical features from the structural aspects. Such an exercise will provide better informed expectations of the medium-term outlook as well as offer policymakers a solid basis for formulating appropriate trade policy and development strategy responses.

5. The Economic and Social Commission for Asia and the Pacific (ESCAP) has dedicated the *Asia-Pacific Trade and Investment Report 2015* to discussing this disentanglement. The Report is divided into two parts. Part I assesses trends and developments in regional trade and investment flows and policies in an attempt to provide the insights and information necessary to separate the cyclical from the structural aspects. Part II analyses the participation of Asia-Pacific economies in global and regional value chains and discusses the degree to which the so-called “new normal” can be traced to their maturation. By observing how Asia-Pacific economies at different levels of development have integrated into supply chains at different speeds and to varying extents, we can also cast light on those policies that influence and shape value chain participation, and hence influence future patterns of trade and investment. The particular features of participation in value chains also have an impact on the ability of countries to access foreign technology and build innovative capacity, which in turn influences structural change and future development options. The main findings of the Report are summarized below.

## II. Recent trends and developments

### A. Merchandise trade: adjusting to slower growth in China

6. Driven by progressively weaker global demand, the growth of world exports slowed substantially from 2.3 per cent in 2013 to 0.6 per cent in 2014. The Asia-Pacific region performed better than the global average with growth in merchandise exports standing at 1.6 per cent in 2014. However, when excluding China from the regional total, exports from the Asia-Pacific region registered a decline of 0.4 per cent.

7. Since the collapse of trade in 2008-2009, Asia-Pacific economies have been reacting to the changed environment in global demand by adjusting their reliance on trade. Trade dependence — measured by the ratio of exports or imports to GDP — is falling for developing and developed economies alike in the region after reaching a peak at the beginning of the financial crisis. Declining trade dependence ratios in developing economies can be attributed to both cyclical and structural factors.

8. Weak external demand, particularly in the economies of the European Union — the region's chief external trade partner — continues to have negative consequences for trade growth. Within the region, continued economic stagnation in Japan is further dampening regional trade figures. While the relatively strong performance of the Indian economy is encouraging, it is unlikely to compensate for sluggish performances elsewhere given that its

market remains only weakly and selectively integrated with the Asia-Pacific region overall.

9. The most notable challenges to regional trade growth, however, are the structural changes affecting the Chinese economy. China is the dominant economic force in the region. In 2007, China overtook the United States of America as the largest individual trading partner for regional economies — a position that it has maintained ever since. By 2014, China was sourcing 41 per cent of its imports from other Asia-Pacific countries, while other Asian and Pacific countries were exporting 19 per cent of their goods to China.

10. While the region has become accustomed to year-on-year double-digit economic expansion in China, recent trends have prompted the International Monetary Fund to revise downwards its annual estimates for GDP growth in China to 6 per cent by 2017. The risks of an even sharper deceleration than anticipated, as well as recent stock market turmoil in Shanghai, have heightened anxieties among policymakers and analysts. Slowing investment in China is having a direct impact on demand (and hence prices) for global commodities. Economies that export to China are seeing declines across primary commodities such as coal, copper, iron ore and palm oil as well as inputs such as steel. In particular, countries with special needs<sup>1</sup> and whose economies are highly reliant on commodity exports to China — such as Kazakhstan, the Lao People's Democratic Republic, Mongolia, Solomon Islands and Turkmenistan — are especially vulnerable to further declines in exports in the short to medium term.

11. The downward pressure is not limited to commodities. Manufacturing exporters such as the Philippines and Thailand are also in an export recession because of the drop in China's processing exports. This, in turn, has led to falling demand for intermediate inputs across the board.

12. While the current slowdown in China is posing challenges to some regional exporters, structural reforms in the country are likely to create new opportunities for others. At present, the Chinese authorities are trying to bring about dual structural shifts in the economy: (a) towards consumption at the expense of investment; and (b) away from manufacturing and towards services. Some success has been observed to date. The share of manufacturing in total output began to decline in 2010 with the share of services overtaking manufacturing in 2012. For countries exporting final goods — especially high-tech and branded consumer goods — rising purchasing power among Chinese consumers offers new prospects. Countries best positioned to benefit include Japan, Malaysia, the Philippines, the Republic of Korea and Singapore. The only real roadblock could be the temptation to implement import-substituting incentives to manage domestic demand. Thus a careful balancing act is needed in order not to stifle these additional opportunities through trade, for both the region and the broader Chinese economy.

13. For other emerging market economies, rising wages in China and that country's move towards higher-end goods and services presents an opportunity to compete with, and potentially replace, China as a hub for low-cost manufacturing. Countries that have competitive labour markets and good access to natural resources will be well placed in this regard. However, the

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<sup>1</sup> Comprising least developed countries, landlocked developing countries and small island developing States. A list of these countries in Asia and the Pacific is available at [www.unescap.org/our-work/macroeconomic-policy-development/countries-special-needs](http://www.unescap.org/our-work/macroeconomic-policy-development/countries-special-needs).

ability to enter global value chains (GVCs) also depends upon other factors, such as the availability and efficiency of trade-related infrastructure, the quality of services such as communications, transportation and logistical networks, access to financing and the ability to access imports (through minimal restrictions on trade) and capital (FDI).

14. Despite the lowering of trade growth prospects, it is likely that the Asia-Pacific region will hold on to its position as the largest trading region in the world. In 2014, the region accounted for almost 40 per cent of global exports and imports, while the share of intraregional trade has remained fairly high and stable over the past decade. Intraregional imports remained at slightly more than 50 per cent of the total in 2014, while the intraregional export share increased gradually to 54 per cent.

15. While these intraregional shares remain high, over half of the intraregional imports in each of Asia and the Pacific's subregions are sourced from East and North-East Asia, and 50 per cent of these are sourced specifically from China. This leaves significant unexploited potential for greater South-South cooperation within Asia and the Pacific. Boosting trade connections between and among other subregions will require improvements in trade infrastructure as well as the development of institutions to support such trade.

16. Taking the above challenges into account, ESCAP anticipates that the growth prospects of merchandise exports by Asia-Pacific economies will continue to soften throughout 2015 before stabilizing in 2016. Across the region, the volume of merchandise exports in 2015 is projected to grow by 2.3 per cent while imports will contract by 2.4 per cent. The contraction of imports is a reflection of the substantial drop in imports by the Russian Federation (-30.4 per cent) and other large declines in imports by the Republic of Korea (-10.8 per cent), Bangladesh (-8.3 per cent), Indonesia (-4.8 per cent) and China (-4.2 per cent). This is likely evidence of the so-called "bullwhip effect" where the demand for intermediate goods is much more sensitive to changes in income than in the demand for final goods.

17. In 2016, trade performances are expected to vary widely across countries, depending on the regional intensity of their trade. Countries such as India and Viet Nam are expected to do relatively well because their exports are largely directed to advanced economies in Europe and North America, which are expected to expand in 2016, while those countries with a heavy reliance on the Chinese market will likely continue their pattern of slow growth.

## **B. Commercial services trade: on the mend?**

18. Global exports of commercial services — which can be grouped into the four broad categories covering travel, transport, other commercial services<sup>2</sup>

<sup>2</sup> The category of other commercial services includes the following subcategories: charges for the use of intellectual property, computer and information services, construction, financial services, insurance and pension services, other business services, personal, cultural and recreational services and telecommunications.

and goods-related services<sup>3</sup> — grew by 4.9 per cent in 2014, slightly slower than the 5.4 per cent growth registered in 2013. Despite the moderation in growth, services trade increased substantially and more rapidly than merchandise trade. Furthermore, even with the global slowdown, Asia-Pacific exports of services increased at a slightly faster rate at 5.1 per cent, compared with 4 per cent in the previous year. Import growth, at 6.1 per cent, was also slightly higher than in 2013. The region remains a net importer of commercial services, accounting for 28 per cent of world exports and 33 per cent of world imports.

19. Exports of travel and other commercial services were especially strong. Expanding intraregional demand for travel by China has been a key factor in this growth. As a result, the region captured an increased share of the global exports of travel services, reaching 34 per cent in 2014 (up from 24 per cent in 2005). Similarly, the region accounted for an increased share of global exports of other commercial services, growing from 19 to 24 per cent during the same period. Export growth for transport and goods-related services was 6 per cent, almost on a par with the world average.

20. Charges related to the use of intellectual property — a subsector in other commercial services — is often linked to a country's capacity to absorb technology and engage in innovative activities. The region runs a deficit associated with the payment of royalties and licence fees, with the notable exception of Japan, indicating that the region is still largely paying for innovation and creativity that is registered, if not necessarily sourced, abroad. As 39 regional economies had royalty and licence fee-related exports worth \$5 million or less, there is a clear need for further encouragement of innovation and, perhaps even more importantly, better intellectual property protection in the Asia-Pacific economies.

21. A small number of regional economies in recent years dominate Asia-Pacific trade in commercial services: China, India, Japan and Singapore alone represent more than half of the region's total trade. Nevertheless, during the past decade, developing economies have been recording growing shares of total regional services exports, especially China and India. From 2005 to 2014, China's exports increased from 15 to 17 per cent of the region's total exports while India's share grew from 9 to 11 per cent.

22. Services trade performance in the rest of the Asia-Pacific region has varied widely. Some countries enjoyed dynamic growth — both in exports and imports — in 2014, while others experienced sharp declines. Armenia, Cambodia, China, the Islamic Republic of Iran and Japan are among those in the former group, having experienced double-digit growth, both in exports

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<sup>3</sup> Goods-related services is a new aggregate combining two subsectors defined in International Monetary Fund, "Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6)" (Washington, D.C., 2009) as: (a) manufacturing services on physical inputs owned by others cover processing, assembly, labelling, packing and similar activities undertaken by enterprises that do not own the goods concerned and are paid a fee by the owner. Only the fee charged by the processor, which may cover the cost of materials purchased, is included under this item. Examples include oil refining, liquefaction of natural gas, assembly of clothing and electronics, assembly, labelling and packing; and (b) maintenance and repair services, not included elsewhere, cover maintenance and repair work — by residents — on goods that are owned by non-residents (and vice versa). The repairs may be performed at the site of the repairer or elsewhere. The value recorded for maintenance and repairs is the value of the work done — not the gross value of the goods before and after repairs.

and imports. Meanwhile, Malaysia, Mongolia, Papua New Guinea, the Russian Federation, Thailand, Tonga and Macao, China recorded falls.

23. Future prospects, as in the case of merchandise exports, hinge on China's economic performance. A continued slowdown is likely to have a negative impact on regional trade. China has become an important importer of services, especially travel services. In tourism, it is estimated that Chinese tourists represent more than 15 per cent of the total arrivals at Asia-Pacific destinations. Countries that attract large numbers of Chinese tourists, such as the Republic of Korea and Thailand, are therefore at risk of a drop in Chinese consumer spending if China's economic growth slows more sharply.

### **C. The Asia-Pacific region maintains its leading role in global foreign direct investment**

24. Fragility in the global economy, creating an atmosphere of policy uncertainty, together with heightened geopolitical risks combined to lower global FDI flows in 2014. Total inflows were worth \$1.23 trillion, a 16 per cent fall from 2013. While developing countries still received the bulk of funds, in 2014 their total amount of FDI (\$730 billion) decreased by 5 per cent. However, this decline was still much smaller than the 28 per cent drop (to \$499 billion) in FDI inflows to developed economies.

25. The Asia-Pacific region remains a major destination for FDI, receiving 43 per cent of total global inflows (\$533 billion) in 2014. While this amount represented an absolute decline of 1.5 per cent from the preceding year, the region continued to outperform the global average. The region is also continuing to gain prominence as a major outward investor. In 2014, outflows from developing Asian economies reached \$450 billion, a 20 per cent increase compared with 2013. This is in contrast to the 15 per cent decline in outflows from regional developed economies.

26. In recent years Asia-Pacific economies have experienced a structural shift in investment inflows. While manufacturing still attracts the greatest inflows — especially in South-East Asian economies that are benefiting from China's rising labour costs — the overall gap with services has narrowed since 2009. Service activities that received the largest FDI inflows include real estate, communications, warehousing and storage, and leisure and entertainment.

27. Changes can also be observed in the preferred mode of investment. In Asia and the Pacific, mergers and acquisitions surged to \$123 billion in 2014, an increase of 137 per cent over 2013. This follows several years of steady growth in mergers and acquisitions activity in the region. Greenfield FDI flows, in comparison, rose a more modest 17 per cent (to \$279 billion). This trend may be a reflection of the uncertain global economic environment leading companies to prefer the relatively less risky route of acquiring existing entities. But it also raises the question as to the extent this mergers and acquisitions activity results in a consolidation of productive activity in the region and reduces competition.

28. Among the Asia-Pacific subregions, developing East and North-East Asia as well as South-East Asia recorded higher FDI inflows and outflows than the other subregions. China became the single largest recipient of FDI globally — surpassing the United States — with \$129 billion in 2014, an increase of 3.7 per cent over 2013. While this can be taken as evidence of increasing Chinese openness, the slow pace of import growth indicates continuing room for improvement.

29. In terms of the region's least developed countries, FDI inflows have been rising continuously, albeit modestly, during the past decade, reaching \$5.1 billion in 2014. While this figure is nearly three times higher than the 2005 total, it still accounts for less than 1 per cent of total FDI to the overall region. Least developed countries have continued to take steps to strengthen their investment environments, addressing liberalization and facilitation bottlenecks. Notably, Bangladesh has had considerable success in attracting steady inflows of FDI for several decades, on account of its liberal investment policy and incentive regimes. Relatedly, Bangladesh also has one of the fastest growing shares of intraregional trade.

30. Broader efforts to spur regional integration will also be significant for the regional investment environment and are likely to support both intraregional FDI flows as well as overall FDI flows to and from the region. In particular, South-East Asian countries are moving towards deeper levels of integration with the forthcoming establishment of the ASEAN Economic Community by the end of 2015. Mega-regional trade agreements such as the Regional Comprehensive Economic Partnership, Trans-Pacific Partnership and the Eurasian Economic Union also have the potential to strengthen and harmonize investment regimes.

#### **D. Trade facilitation measures reduce trade costs and improve competitiveness**

31. Recent global events, such as the successful conclusion of negotiations on the World Trade Organization (WTO) Agreement on Trade Facilitation (December 2013), have brought trade facilitation into sharp focus. It is clear that implementation of the WTO agreement will become the new standard for trade facilitation as a means of reducing trade costs. Trade costs play a significant role in shaping regional and global trade patterns and thus in determining the distribution of benefits. Trade costs also shape consumer welfare by acting as a factor determining the price and the diversity of available goods.

32. Trade costs vary widely across subregions. East Asian countries typically have the lowest trade costs of the region, on a par with those of the large European Union economies. While the trade costs of North and Central Asian economies remain about three times higher than those of East and North-East Asia, the former have made the most progress since 1996 in reducing these costs. South Asian economies have also made important strides in reducing their trade costs. In contrast, the Pacific Islands developing economies have the highest overall costs and have displayed no clear improvement.

33. ESCAP research has found a strong correlation between the levels of implementation of trade facilitation by Asia-Pacific economies and their international trade costs. The results show that trade facilitation implementation levels explain (a) about 45 per cent of the variations in trade costs, and (b) that a 1 per cent increase in the level of trade facilitation implementation is associated with a decrease in trade costs of 2.3 per cent. This highlights the benefits of pursuing trade facilitation measures with a view to increasing competitiveness and expanding trade opportunities. The Global Survey on Trade Facilitation and Paperless Trade Implementation initiated by United Nations Regional Commissions shows wide disparities in trade facilitation implementation levels among regions, with the highest average levels of implementation recorded for developing countries in Latin America and the Caribbean and South-East Asia and selected



developing countries from East and North-East Asia,<sup>4</sup> while the Pacific region lags significantly behind most others in this area.

34. In the case of the Asia-Pacific region, the Survey compiled data for 44 economies representing five subregions. Overall, the average level of trade facilitation implementation by the 44 Asia-Pacific economies, based on a set of 31 trade facilitation and paperless trade measures, is 46.5 per cent. Within the Asia-Pacific region, Australia, the Republic of Korea and Singapore have obtained scores in excess of 85 per cent, while other countries have yet to achieve 15 per cent implementation levels.

35. The progress of countries in relation to specific trade facilitation measures is also mixed. The trade facilitation measures related to enhancing transparency and the reduction of formalities have the highest levels of implementation, as all countries in the Asia-Pacific region are engaged in the implementation of such measures. Overall, the least implemented measures in the region are those in the cross-border paperless trade category; in fact, the category of measures showing the widest implementation disparities is paperless trade.

36. As this report shows, ESCAP estimates that full region-wide implementation of cross-border paperless trade can bring about export gains of the order of \$257 billion annually. Work being done by ESCAP members and associate members towards a regional arrangement on cross-border paperless trade furthers the objective of the Asia-Pacific region to achieve more efficient flows in this area as well as building synergies with other ongoing initiatives including the WTO Agreement on Trade Facilitation. The negotiations on this regional arrangement present an opportunity for economies to cooperate on cross-border paperless trade implementation in order to promote the seamless exchange of information and documents along international supply chains.

37. While moving towards more competitive supply chains involves the seamless exchange of data and documents, it also requires the efficient movement of physical goods themselves across borders. Countries in the Asia-Pacific region have been making progress in overall international supply chain connectivity, with countries of East and North-East and South-East Asia remaining regional and global frontrunners. However, the subregion that has shown the greatest progress in international supply chain connectivity between 2009 and mid-2015 has been North and Central Asia.

## **E. Trade policy: tipping the balance away from protectionism**

38. The tipping of the balance between liberalizing and trade-restrictive measures away from the latter should not engender complacency among regional policymakers. While globally the number of trade-liberalizing measures slightly outpaced trade-restrictive measures in the most recent reporting period, the same cannot be said for the Asia-Pacific region. In the region, 108 new trade-restrictive measures were recorded in the mid-November 2013 to mid-May 2015 period compared with 80 liberalizing measures. This worked out as an average of six new restrictive measures being introduced each month compared with just over four liberalizing measures. Asian and Pacific economies accounted for 40 per cent of all trade-restrictive measures introduced globally — up from 38 per cent in the

<sup>4</sup> As regards the Asian subregions: Brunei Darussalam; Cambodia; China; Indonesia; Lao People's Democratic Republic; Malaysia; Mongolia; Myanmar; Philippines; Republic of Korea; Singapore; Thailand; Timor-Leste; and Viet Nam.

previous period — but only 27 per cent of liberalizing measures. Indonesia and India were the two economies responsible for the largest number of new trade-restrictive measures, with 28 and 22 measures respectively. The majority of new trade-restrictive measures were tariff increases.

39. Trade remedy measures give Governments some flexibility in the application of their WTO commitments allowing them to respond to particular situations, typically by imposing temporarily higher tariffs on imports from particular sources. During the reporting period, 263 new trade remedies were initiated, with 97 in the Asia-Pacific region, a modest decrease from the previous period. Both globally and in the Asia-Pacific region, initiations slightly outstripped terminations, leading to a small increase in the overall number of measures restricting trade. By far the most common form of trade remedies remained anti-dumping initiations. India was the top initiator of new trade remedies, introducing 34 during the reporting period.

40. The sustainable development goals recognize the importance of trade as an engine of growth and development, and prioritize the expansion of engagement by least developed countries in international trade. If the ambitious goal of doubling the share of global exports from least developed countries is to be met, it will require concerted actions to ensure meaningful market access for their goods and services.

41. For trade in merchandise goods, non-reciprocal preferences have helped least developed countries to export to developed and some developing economies. These schemes include the Generalized System of Preferences and, more recently, duty-free quota-free programmes. As part of the WTO “Bali package” agreed in 2013, developed countries committed to offering duty-free quota-free access to at least 97 per cent of products originating from least developed countries on a tariff-line basis (although many were already doing so). At present, all developed economies meet this requirement, with the exception of the United States and the Russian Federation. Many developing countries in the region, including China, India, the Republic of Korea and Thailand, are also introducing preferential schemes. For least developed countries to reap the full benefits of available preferences, however, restrictive rules of origin and other non-tariff barriers need to be tackled.

42. In services trade, there has been some recent progress in implementing the 2011 “services waiver”, which provides the legal framework for allowing countries to give better than most-favoured-nation treatment for least developed countries services and service suppliers. At a meeting of the WTO Services Council in February 2015, more than 25 WTO members provided indications of the preferential access they were prepared to offer and by August 2015, 11 members had submitted official notifications. Early evaluation of these offers suggests that a majority of the sectors collectively requested by the least developed countries were covered to some extent. However, the limited progress on Mode 4 access (covering the movement of natural persons) — for example, through visa requirement waivers — implies that preferential access will fall short of meeting the full request by least developed countries. Yet, timely progress towards implementation remains important because the lifespan of the waiver extends only until 2026.

## **F. Trade agreements: awaiting the mega-regionals**

43. The slow progress in multilateral trade liberalization through the WTO Doha Round has prompted countries to seek new trade opportunities elsewhere. Many Asia-Pacific economies continue to pursue preferential

trade agreements (PTAs) with partners both within and outside the region. Between January 2014 and June 2015 a number of new trade agreements were signed, including deals between Malaysia and Turkey, China and Australia, China and the Republic of Korea as well as Japan and Mongolia. In addition, several previously-signed agreements came into force, including China-Switzerland, Singapore-Taiwan Province of China, China-Iceland, Hong Kong, China-Chile, Republic of Korea-Canada and Thailand-Peru agreements. At present, there are more than 231 agreements associated with Asian and Pacific economies, of which 155 are in force.

44. Despite this activity, the pace of concluding new agreements, especially bilateral ones, has slowed somewhat. From 2010 to 2014, an annual average of 6.5 PTAs involving regional economies were brought into force, compared with an average of 9 per year between 2005 and 2009. This slowdown may reflect the fact that the attention of regional policymakers is increasingly being taken up by the negotiation of the so-called “mega-regional” deals — the Regional Comprehensive Economic Partnership and the Trans-Pacific Partnership — each of which involves several regional economies.

45. Existing PTAs in the Asia-Pacific region vary significantly in their scope and coverage. More than half of all agreements brought into force create free trade areas for trade in (merchandise) goods, while a further 39 per cent of agreements allow free trade of both goods and services.

46. While Asia-Pacific economies have undertaken more PTAs than any other region, they remain reluctant to form common customs territories. In fact only one regional customs union, the Eurasian Economic Union, exists, apart from the one between Turkey and the European Union. Despite this apparent reluctance for deep integration, countries are going beyond traditional “free trade areas” to create economic or comprehensive partnership agreements. These agreements include commitments to liberalize areas not covered by WTO disciplines at present, such as investment and government procurement. The number of agreements containing these areas of liberalization featuring “next generation” trade issues is still low, however.

47. The extent to which economies in the Asia-Pacific region trade with their PTA partners varies considerably. Only 35 per cent of exports and 45 per cent of imports are transacted with the PTA partners for all the economies in Asia and the Pacific (as a simple average for the period from 2011 to 2013). Least developed countries such as Afghanistan (72 per cent), Bhutan (88 per cent), the Lao People’s Democratic Republic (86 per cent) and Myanmar (92 per cent) show a very high share of exports with their PTA partners, typically neighbouring nations. At the other end of the spectrum, the Pacific Island countries export less than 10 per cent of their total exports to PTA partners and the figure for North and Central Asian economies is only 16 per cent. Import patterns are likewise diverse. Some countries show much higher propensity to import from PTA partners compared with their export pattern, for example Bangladesh (60 per cent), Cambodia (90 per cent), Macao, China (60 per cent) and Sri Lanka (51 per cent), while some others tend to import much less from the PTA partners than what they export to them (for example, in the case of Afghanistan, Bhutan and some Pacific islands).

### **III. Supporting participation in value chains**

#### **A. Value chains in today's Asia-Pacific region**

48. The international fragmentation of production in GVCs has been a defining feature of trade and overall economic development in Asia and the Pacific. Although the international exchange of inputs along a value chain is not new, the rapid growth in the scope and complexity of GVCs since the late 1980s is unprecedented. Experience from the region shows that even small developing countries can be important players in GVCs, by specializing in a particular stage of production, with significant benefits for development.

49. The unbundling of the production process in the GVC phenomenon occurs across both countries and firms. Trade liberalization as well as improved communications and logistics have made it easier than ever to separate the individual functions in a value chain, which can then be located anywhere in the world. Business activities at different stages of value addition, such as research and development, design, production of parts, manufacturing assembly, marketing and branding, are frequently located in different countries with each activity taking place where it can be most efficiently produced or supplied. Although the nature of GVCs may be sector specific, they all typically involve the movement of intermediate goods through successive countries. The expansion of GVCs has been particularly pronounced in sectors such as apparel and footwear, automobile, electronics and the agrifood industry.

50. Participation in GVCs can be an important contributor to sustainable development. A greater division of labour and the segmentation of production on a global scale allow a larger number of countries to benefit from trade. With today's GVCs, countries do not need to develop sophisticated and vertically integrated industries to participate in global trade; it is enough to develop capacities in specific stages of production, tasks or business functions. In other words, even small developing countries with limited capacity now have a chance to undertake tasks that would have previously been executed in developed countries, thereby creating local jobs and value-added. GVC participation also produces wider economic spillovers in terms of improved productivity and heightened competitiveness.

51. There are, of course, downsides. The widespread contraction in trade and investment in the aftermath of the financial crisis demonstrated very clearly that economies interconnected through GVCs either swim or sink together. Because of efficiency reasons related to the operation of GVCs, these economies have to be open; as a result, the transmission of external shocks is, as seen in 2008 and 2009, fast and extensive. The immediate impacts of demand shocks in these economies are strong but, judging from the performance of Asian economies, their recovery is equally fast. Participation in GVCs was one of the key factors contributing to the export recovery of those economies; the more diversified and networked the economies were, the easier it was for them to emerge from the export contraction. However, Governments still need to be mindful of downside risks in order to ensure that GVC participation is accompanied by policies for managing exposure to external shocks and preventing exacerbated inequalities or environmental degradation.

52. Empirical evidence shows that GVCs are often strongly regional in nature. This fact has played out in the Asia-Pacific region by opening up opportunities for deeper integration within the region. For example, technology-intensive electronic parts and components are produced in

relatively advanced countries such as Japan and the Republic of Korea. The assembly of intermediate components into finished products, meanwhile, is typically taking place in emerging economies, such as China and Viet Nam. Intermediate goods trade now accounts for about 22 per cent of total regional trade.<sup>5</sup>

53. The linkages between regional value chains and PTAs are complex and not easily generalized. The Asia-Pacific experience shows that regional value chains were established even while the connected economies did not share too many formal PTAs. As GVCs became established in some regional economies, their further expansion needed policies for reducing operation costs. ESCAP research shows that PTAs alone will have limited benefits unless they are part of more comprehensive liberalization and facilitation policies, including multilateral and unilateral efforts. Results suggest that PTAs may be particularly supportive of GVC-related exports to countries outside the region: having a PTA may increase final exports to the world by 73.9 per cent, while the impact on intraregional exports is only 58.6 per cent. A possible explanation could be that formal trade agreements may not be crucial to driving GVC trade at the intraregional level because Asia-Pacific economies are already connected through the regional production networks established by multinational corporations.

54. In addition, the effectiveness of PTAs in helping GVC-related exports appears to depend on the development levels of exporter and importer economies. For example, having a formal trade agreement will significantly help low-income countries to export to high-income countries. The same cannot be said for countries that are not in a group of high-income countries. The result appears to be the opposite when looking at exports from high-income countries, namely, PTAs do not help exports to countries in the same peer group. In contrast, having a PTA plays a significant role in helping low to middle-income countries increase their exports to intraregional markets, regardless of the level of income.

55. Although the results are quite mixed, a general conclusion seems to be that having a PTA with high-income import partners might be a useful strategy for Asia-Pacific exporters in both low and middle-income groups. Given the fact that high-income countries are likely to be the large market for intermediate and final products in GVCs, this finding implies that a PTA strategy that might effectively help GVC-related exports by low and middle-income Asia-Pacific countries would be the market-driven PTAs.

56. Today, the Asia-Pacific region is a major exporter of GVC-produced final products, but not yet a major source of final demand. In 2013, the Asia-Pacific region accounted for about 45 per cent of the world's GVC-related exports of final products, with around half coming from China alone. In contrast, the region only accounted for around 26 per cent of final product imports. The United States and European Union countries remain the most significant importers of final products. This pattern is gradually shifting though: the region has increased its share of final imports by 7 percentage points between 2007 and 2013.

57. Intraregional trade, especially South-South trade, is playing an increasing role in GVCs. The share of intraregional exports in total intermediate exports by Asia-Pacific countries grew gradually from 52.6 per cent in 1995 to 58 per cent in 2013. Intraregional imports of

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<sup>5</sup> A detailed list on intermediate goods included is provided in annex B of chapter 7 of the Report.

intermediate goods are especially important. In 2013, more than 65 per cent of the GVC-intermediate imports of Asia-Pacific countries came from countries within the region. Regional import intensity was particularly high for apparel and footwear, and electronics with shares of intraregional intermediate imports as high as 91.5 and 82 per cent, respectively.

58. While GVCs can open up opportunities for nearly all countries, at present GVC-related trade in the Asia-Pacific region is highly concentrated in just 10 economies. Indeed, 90 per cent of these trade flows are concentrated in the following countries: Australia, China, India, Indonesia, Japan, Malaysia, the Republic of Korea, Singapore, Thailand and Turkey. Low-income countries are thus at present not fully participating in the spread of GVCs across the region. In most sectors, low-income countries represent a negligible share of final exports with the exception of apparel and footwear, mainly from Bangladesh and Cambodia.

## **B. Availability of services crucial for global value chains**

59. While GVCs are most clearly observed in manufacturing production, services create a significant proportion of the value in the process of manufacturing, distribution and marketing of goods. The growing use, both direct and indirect, of locally produced and traded services, by the manufacturing sector in this process has become known as “servicification”. Better statistical tracking of trade in value-added has uncovered the extent to which services contributed to trade values. The increased importance, or servicification, implies that access to services has become a key factor in enhancing the competitiveness of economies, especially those exporting industrial products through GVCs.

60. In fact, GVC-related production and trade have spread more extensively through the Asia-Pacific region than in the rest of the world, which implies the great importance of servicification, *inter alia*, to the development of the region’s industrial exports. ESCAP analysis shows that services accounted on average for 29.4 per cent of the total value-added in the industrial exports of Asia and the Pacific in 2009, which is on a par with the global average of 29 per cent, but considerably lower than the European Union average of close to 55 per cent. Data from the Organization for Economic Cooperation and Development-WTO Trade in Value-Added Database show that the spread of GVCs in the region has also resulted in an expansion of servicification across Asia-Pacific developing economies. Indeed, the share of intraregional imports of services has increased, especially in GVC-related industrial exports. The Republic of Korea and China are the economies that benefited the most in terms of intraregional export growth in services. In contrast, Japan has lost market share.

61. Distribution-related services and business services are the major elements of service inputs to industrial exports from Asia and the Pacific. These services accounted for 9 and 7.5 per cent, respectively, of industrial exports from the Asia-Pacific region in 2009. Business services contribute extensively to the exports of electrical equipment, machinery and transport equipment. These equipment exports happen to be the sectors where multinational corporations have an intensive presence.

62. Although domestic sourcing of services remains dominant, especially in the cases of agriculture and mining exports, the contribution of imported services has been rising. The share of imported services in industrial exports increased from 7.6 per cent in 1995 to 11.1 per cent in 2009. The increase in

service imports is particularly rapid in the case of business services, but it is also important in other subsectors.

63. Liberalizing services trade would allow more efficient imports of services inputs and facilitate the competitiveness of the Asia-Pacific region's industrial participation in GVCs. Liberalization should not be restricted to regional South-South flows, as developed economies remain the dominant source of imported service inputs.

### **C. Global value chains, technology transfers and innovation**

64. From a development standpoint, an early stage in GVC participation typically involves labour-intensive low value-added operations, such as product assembly. However, on reaching higher levels of development there is the possibility of specializing in higher value-added tasks, such as component manufacture, ultimately culminating in research and development. Higher value-added tasks are often accompanied by positive spillovers in terms of technology, productivity and skills upgrading, which ideally lead to endogenous technology creation. Identifying the policies needed to support "moving up" value chains is therefore important.

65. When an upwards GVC partner or lead firm (assumed to be located in a developed country) makes a conscious decision to transfer technology downwards to a firm in the supply chain (in a developing country), this is an important vector supporting value chain upgrading. The business case for such a transfer is that it can help the firm in the developing country to produce more efficiently, which in turn has benefits for the entire value chain. Empirical analysis of the relationship between GVCs and technology transfer has found a number of channels through which this can take place.

66. One common way in which GVC participation can lead to technology transfer and upgrading is FDI. A country's investment climate is therefore an important determinant of a lead firm's appetite to undertake FDI. Empirical evidence bears out the contention that FDI can be a vector of direct technology transfer at the firm level. After controlling for country, time and sector-specific factors, foreign-owned firms are, on average, 82 per cent more productive than domestically owned firms, which is consistent with foreign-owned firms having access to superior technology.

67. Another way in which GVCs can facilitate technology transfer is through the licensing of technology by a foreign firm to domestic producers. In this case, the lead firm or technology supplier does not take an equity position in the firm receiving the technology, but instead allows it to use the technology in return for payment of a fixed sum. This can be an important source of competitive advantage as firms that license foreign technology are, on average, 48 per cent more productive than firms that do not license foreign technology.

68. It is also possible to gain access to technology within a GVC through transactions in the marketplace. One example is importing appropriate capital goods, such as machines and equipment. Access to world markets for intermediate goods gives firms the ability to use high-quality inputs that may not be available domestically. Imported capital goods can generate spillovers, as workers learn how to use them and can then take that knowledge with them to other firms that can themselves acquire the same technology. Firms that import at least some intermediates are, on average, 38 per cent more productive than firms that use only domestic intermediates.

**D. Policies for supporting participation in global value chains**

69. Given the benefits of engaging in GVC-related activities, policymakers should consider actions that support entry into value chains, improve competitiveness, facilitate upgrading and support sustainable development more broadly. Empirical analyses undertaken by ESCAP as well as evidence from other studies point to a number of key recommendations.

**1. Securing entry to global value chains**

70. As many smaller and low-income regional economies are not yet fully integrated into GVCs, the key question for policymakers is how to create an enabling environment for local firms to gain entry into existing networks. In this regard, it has been found that:

(a) Trade cost reduction is essential for a country to participate more effectively in GVCs and overcome geographical disadvantages. Trade costs comprise one of the key determinants of a country's performance in GVCs. Trade-cost reduction policies include liberalization of trade in goods, services and investment, with a removal or reduction of direct and indirect barriers;

(b) Trade facilitation, development of ICT infrastructure, improved logistics performance, regulatory transparency and other policies that reduce broader behind-the-border obstacles to trade are necessary conditions for GVC participation;

(c) Regional economic integration agreements could be a catalyst in enhancing GVC participation of developing Asia-Pacific countries, provided such agreements are deep in commitments and broad in scope and coverage. However, bilateral and regional trade agreements will have little effect without the implementation of necessary domestic trade reforms — in particular, trade facilitation. Furthermore, there is a need to rationalize and consolidate existing preferential trade agreements as their effectiveness may face adverse impacts through the noodle bowl phenomenon;

(d) Enabling GVC development will increasingly require more international cooperation and coordination among Governments. The need to harmonize domestic rules and regulations with international standards is particularly strong in Asia and the Pacific, as burdens created by those rules and regulations can be amplified across GVCs and result in damage to region-wide competitiveness;

(e) There is a need to increase the involvement of low-income countries in GVCs. The dynamic nature of GVCs may offer new opportunities for countries that have, thus far, not been integrated into regional trade. The key to unlocking the potential of low-income countries is infrastructure development, especially in relation to trade facilitation;

(f) Once a country is significantly integrated into GVCs, Governments should pay attention to the broader policy environment. Domestic policy and regulatory reforms to facilitate trade and business operations help to maintain attractiveness to FDI as well as preserve competitive advantages.

**2. Realizing the potential of services in supporting global value chains**

71. The importance of servicification requires a comprehensive approach to policy formulation. While liberalizing trade in goods is a starting point for



creating new trade opportunities, the value chains of industrial goods also require efficient services. The findings of the Report show that:

(a) Improvements in the performance of the service sector, including through liberalizing services trade, will enhance the competitiveness of manufacturing firms and facilitate their participation in global production networks. Many regional economies maintain highly restrictive services sectors, which could hamper efforts to promote goods exports;

(b) There is a risk that too much reliance on imported intermediate services and goods may lead to limited development spillovers from GVCs to the rest of the economy. The general direction of service trade policy should then focus on creating competitive market conditions and developing a well-functioning domestic service sector that meets high regulatory standards;

(c) Measures need to vary from sector to sector. For example, ensuring access to the grid or network for new entrants in the telecommunications or electricity sectors should help in creating a level playing field and result in pro-competitive efficiency gains;

(d) Openness of financial services with a good regulatory framework could enhance competition and stability in the financial sector and contribute to macro stability. In addition, it is important to have a comprehensive set of policies in place in order to encourage spillovers and technological diffusion from foreign to domestic providers. This may include, for example, public investment to upgrade and improve accessibility to backbone infrastructure such as railways, ports, health and education;

(e) The provision of education and training (e.g., in ICT, languages and professional skills) as well as greater domestic and international labour mobility will enable domestic firms as well as individuals to take advantage of service-export opportunities.

### **3. Facilitating technology transfer and moving up the value chain**

72. Developing country firms and workers can only benefit from new technology through GVC participation if the domestic policy environment is right. Smooth transitions from labour-intensive to skills-intensive segments of GVCs need enabling policies to facilitate the adjustment process through well-designed labour market and social reforms, and investment in education and skills. This requires several actions, including:

(a) Building institutional capacity — including governance, the rule of law and contract enforcement — and respecting intellectual property rights for securing the benefits of technology transfers. All types of technology transfer within GVCs rely on some type of legal relationship between the source and the recipient;

(b) Openness to FDI is one of the most vital and beneficial vectors for technology transfer within GVCs. In many countries, excessive restrictions remain, particularly in services. Appropriate relaxation of foreign investment rules — which includes limits on foreign ownership and legal forms — can encourage GVC partners and lead foreign firms to strengthen relationships with local firms, including through technology transfers;

(c) Maintaining an open stance by developing countries in relation to international trade, particularly in the case of intermediate inputs and capital goods. A liberal trade policy stance facilitates movements of goods that bring technology embedded in them;

(d) Development of human capital to improve the capacity of firms to absorb technology transfer. For technology transfer to be fully effective, the new machines or techniques need to be understood and internalized as well as potentially adapted to domestic conditions, both by workers and by local engineers.

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