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Three Paths to Enter Global Value Chains

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Wood products are loaded at Tanjung Priok port, Jakarta port, Indonesia prior to shipping. Global value chains refers to the trade in intermediary products, where production of a final product is spread across numerous countries.

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The policy prescriptions attached to Global Value Chains are worryingly unsubstantiated, writes SAIIA's Christopher Wood.

As the African Development Bank celebrated its 50th anniversary in Kigali at the end of May, it could look back on a history that has overseen drastic changes in the way the global economy works, and one change in particular was on everybody's lips. The AfDB joined the WTO, WEF, IMF, and an ever-growing list of organisations committed to understanding the hottest acronym of 2014: GVCs.

Global Value Chains (GVCs) refer to the increasing trade in intermediate goods, which now encompasses up to 60% of world trade. Instead of one country producing a final product, production is spread across numerous countries. A car may be designed in Germany, its parts produced in Vietnam and China, and assembled in South Africa. The shift is drastic and important, offering numerous key insights into how world trade works.

The core insight of GVCs is that development policy must move away from a focus on building an entire industry, stretching from raw materials to the final manufactured good, towards a focus on entry into specific niches within global value chains. This holds a lot of promise for Africa, because it might mean jobs can be created in intermediate production without having to undertake the long and difficult process of becoming competitive in complex final goods like cars or airplanes.

But the step from exploring an empirical phenomenon to offering policy advice is a tricky one, and the GVC narrative is stumbling.

Liberalisation to Enter

The core policy prescriptions that mostly accompany GVCs could be described as Liberalisation to Enter. This line of thought argues that in order to enter GVCs, African countries should lower trade barriers, decreases transport costs, and support the growth of the services sector.

On one level, this advice seems intuitive. Competitiveness in global value chains is intimately connected to trade costs. African firms could produce a widget at $1 when it costs $2 in China - but if tariffs, inefficient border posts and high transport costs add an additional $1.50, then the continent will not be competitive and will not be able to enter GVCs.

These barriers could also undermine local manufacturers aiming to produce final goods. Traditionally, liberalisation might have been opposed in an effort to give infant industries the chance to develop adequate productive efficiency to compete in the world market. But in a world of GVCs, trade barriers directly undermine the efficiency they are trying to create.

The ability to compete is no longer just about having the best factory that can produce the best end product at the lowest cost, but is about being able to source the best inputs at the lowest possible cost from the global market.

These arguments certainly hold a lot of truth, but they have been overplayed as decisively shifting the ownership of GVCs towards liberalisation. Policy-making is about a choice between mutually exclusive options. And the arguments supporting other options – such as strategic protectionism and industrial policy – are also made stronger by GVCs.

Protect to Enter

Liberalisation would definitely be the right move if trade barriers were all that were holding African firms back from entering GVCs. But there are many more fundamental competitive problems.

Even if we set aside the structural barriers that remain in the way of African manufacturers – such as inefficient infrastructure, inadequate power grids, skills shortages, and weak economies of scale – most African countries lack the history of industrialisation that is necessary to compete in component manufactures. Most German cars are no longer produced in Germany, but they were for a hundred years. And during that time, the country developed knowledge of automotive production and of how the components fit into the bigger production chain. This history of industrial production left the skills, industrial infrastructure, and supplier relationships (up and down the supply chain) that make German component manufacturers competitive.

While some skills can be imported or learned along the way, it seems unlikely that this would be enough in the short term for African countries to overcome the competitive advantage of those with organic skills and much more advanced infrastructure. Liberalisation in the face of this competitive deficit would therefore not facilitate entry into GVCs, but would rather facilitate foreign entry into local value chains. Without a stronghold customer base in their own country, it seems unlikely that African firms could survive long enough to develop the knowledge and scale to enter into global value chains. To develop in scope and efficiency – and to enter GVCs – these firms might have to be protected from too harsh exposure to the forces of international competition.

This is not to say that firms will fail as a result of trade liberalisation, nor to suggest protectionism as a development strategy. It is simply to note that protection-minded individuals have no reason to change their opinion as a result of GVCs.

Support to Enter

GVCs have a similarly ambiguous effect on the industrial policy debate. Proponents of liberalisation might see such interventions as unnecessary and possibly distorting. And yet South Africa's most successful entry into value chains, in automotives, is arguably due to support under the Motor Industry Development Programme. More fundamentally though, GVCs could also offer a means of hedging risks in sectoral level strategies.

Indonesia offers an illustrative example. Decades of industrial support were pumped into PT Dirgantara Indonesia (PTDI), the state-owned aircraft manufacturer, and yet the company never produced a successful plane. But in failing, PTDI and the Indonesian aviation sector developed the skills to produce various crucial components, including wing-ribs for Airbus's flagship A380. The result was PTDI's entry into global value chains, and estimated sales of $365 million in 2013. With the advent of GVCs, the success of industrial support is no longer tied to the success of the final product manufacturer, but could apply to all the various stages and connections of the production process.

Again, this is not to argue that targeted industrial policy is always the right policy, it is simply to say that GVCs do not change the logic of the industrial policy narrative, and might even strengthen it.

Beyond Ideology

The concept of global value chains offers fascinating insights into the evolving nature of global trade. But GVCs do not change the basic trade debate: they can strengthen the case for both liberalisation and intervention. The true policy implications of GVCs remain uncertain. To overcome this uncertainty, they should not be assumed to support a given set of policy actions. Tying GVCs to one side of the debate can only diminish the concept in the eyes of those with different opinions.

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