

# Economic Issue of the Day



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## Global value chains

Nearly everything we consume today—both products and services—are put together by people and firms dispersed across the globe, whether we realize it or not. The world is ever more connected by interdependent networks through which exchanges of products, ideas, and activities flow.

These networks are considered global value chains (GVCs). GVCs pertain to the life sequence of any given product or service, from the moment an idea is conceived, through its creation, transformation, transport, delivery, and, finally, its utilization.

This phenomenon of fragmented production is not new. Business firms and countries have always outsourced the production of trade goods and services to some degree. But with the dawn of the Internet, among other pivotal technologies, interdependence across borders has intensified. The reduced costs of communication and transportation, and the incentive of cheaper labor across borders have enabled GVCs to flourish.

It is important to understand how GVCs work, their role in promoting more inclusive economies, and the policy areas necessary to address in order to fully capture the benefits of GVCs in enhancing the economies of developing nations (Elms and Low 2013).

### Parts and elements

Structurally, GVCs are made up of firms and people who affect the activities of the chain, and of government leaders and policymakers who affect the environment in which chains operate. Firms can be large multinationals that set the standards and parameters of a chain because of their market advantage in key components and technologies (Gereffi et al. 2005). But they can

also be small and medium enterprises (SME), sought for their creativity, resourcefulness, and innovative solutions (Elms 2013).

SMEs are touted as the true drivers of innovation and economic development (Elms 2013). Many developing economies rely on SMEs to spur growth and create employment. Gaining access to GVCs helps SMEs expand their operations, enter the international market, gain access to foreign equities, and earn wider business exposure. Beyond entry and increasing participation in a GVC, the bigger goal for SMEs is to rise above a chain. They have to innovate and upgrade their capabilities to be able to compete in offering niche products, processes, and services, and, in turn, contribute higher added value to the production process (Philexport News and Features 2013).

In the Philippines, 99.6 percent of all registered businesses are classified as SMEs. They generate more jobs than all other types of business establishments (DTI 2014). Getting them integrated into value chains helps them grow their revenues. For example, a study by Briones and Galang (2014) shows that small-time tobacco farmers have benefited from being part of a value chain than from being part of a traditional marketing system. Contract farming cuts down the middlemen traders and helps farmers to have direct access to buyers, who indicate their preferred plant variety and management practice and provide farmers other means of support like cash advances. Farmers who are part of value chains generate higher net farm income than their noncontract counterparts (Briones and Galang 2014).

### Success stories

Two export sectors in the Philippines can be considered GVC success stories—the semiconductors and electronics

industry and the business process outsourcing (BPO) industry. The electronics industry has been considered the Philippines' "most important" export sector because it makes up 60 percent of the country's total export trade (Aldaba 2015). The industry's direct employment grew by 27 percent between 2013 and 2014; it currently employs indirectly 2.3 million Filipino workers (Aquino 2014). The turnover rate is 5 percent annually, meaning, Filipinos stay longer in semiconductors and electronics than in companies from any other industry, thereby able to enhance their skills and efficiencies through tenured work experiences.

But according to Aldaba (2015), the participation of the Philippine semiconductor and electronics industry in GVCs is confined to labor-intensive and back-end assembly, testing, packaging, shipping, and the like. Business firms and government policymakers need to work together and "reposition" the industry to upgrade and capture front-end segments like design and development, where the higher added values are located. Upgrading involves commitments from both the industries and policymakers such as investing in human capital enhancement, creating a conducive business environment, investing in research and development (R&D), strengthening cooperation among sectors, improving logistics and infrastructure, enforcing protection of intellectual property rights, and making regulations more transparent.

Meanwhile, the BPO industry has propelled the country to become one of the leaders, alongside India, in the Asia-Pacific region in the area of trade in services (del Prado 2015). The Philippines owes its success partly to the advances in information and communication technologies and infrastructure, and to the changes in the way people do business. More importantly, its highly educated and skilled labor force, which gives value for money, has continuously attracted BPO firms of every category, from voice-based and nonvoice-based business processing management to animation and software development. The Bangko Sentral ng Pilipinas puts the revenue generated by the local IT-BPO industry at 5.4 percent of the gross domestic product in 2011 (del Prado 2015). Services trade is estimated to grow in the coming years, particularly the global IT-BPO market, and the Philippines has not only been performing well but has also remained competitive and has maintained the status of being the choice destination (del Prado 2015).

### Prospects

The benefits of participating in a GVC are neither automatic nor given, and the scenarios are nuanced. Currently, there is a significant slowdown in the growth of global and regional trade and investment since the financial crisis of 2008 (UNESCAP 2015). A combination of continued Chinese economic slowdown and a dip in global demand is expected to put a dent in the export growth of developing countries in the Asia-Pacific region. Those participating in global and regional value chains are sure to feel the impact.

That is not to say that participating in GVCs is no longer profitable—opting out may not be an option at all. Competitiveness of economies now relies heavily on links to global markets, and GVCs have assumed the main role of facilitating the exchange of all goods: capital, knowledge, technology, standards, and value-added services (Cattaneo et al. 2013).

To fully optimize participation in GVCs, the key for policymakers is, firstly, to create a comprehensive framework that recognizes and capitalizes on their country's competencies. The aim is not to capture an entire chain. They must consider their country's competitive advantage, and develop the innovation, skills, R&D, logistics, marketing, and other infrastructures needed to capture the GVC segments in which their firms can compete best.

Secondly, developing countries like the Philippines should consider increasing their participation in regional and intraregional GVCs, and tap into the "unexploited trade potential" of the Global South (UNESCAP 2015). The positive growth of intraregional export trade between 2002 and 2014, from 46 percent to 54 percent, underlines the positive impact of participating in segments of regional networks. Southeast Asian economies, in particular, have posted high intraregional trade intensity. Experts have attributed this to the increasingly high participation rate in regional value chains.

The launch of the ASEAN Economic Community (AEC) is expected to intensify the growth and expansion of regional trade in goods and services. The integration will oblige member-states to reduce tariff and nontariff barriers, improve hard and soft infrastructure, reform policies and regulations systems, and engage in mutual agreements to improve the regional and national business environments. Once the commitments are fulfilled by member-states, the AEC economic integration will create greater trade openness in the region. Goods, services,

investments, capital, and labor will flow more freely across borders, and this will positively affect producers and consumers by helping shape a more dynamic regional market (Aldaba et al. 2013).

### Policy areas

Philippine policymakers have to work with firms to maintain and improve the momentum of its economic growth vis-à-vis its participation in regional value chains. Because the country's enterprises are made up of SMEs, leaders must create policies and programs that will assist SMEs to increase their participation in value chains.

R&D investment is a key component in developing capabilities for SMEs to upgrade and expand. At present, Philippine SMEs find it particularly challenging to innovate their products and the way they do business (Patalinghug 2015). Llanto and del Prado (2015) established the relationship between innovation and improved economic performance. One of the major obstacles that hinder small businesses to innovate is access to credit.

In the Philippines, SMEs experience a huge difficulty in gaining capital and must often rely on acquiring capital informally (Lamberte and Gaudena 2015). They are disadvantaged from acquiring and accessing credit because of many restrictive laws that hinder both SMEs and lending institutions from engaging with one another.

Policymakers must develop comprehensive and centralized credit information system for both firms and banks to utilize. Making it easier for SMEs to access finance and invest in innovations will improve their chances of joining GVCs.

Apart from innovation and credit, one of the biggest barriers hindering the Philippines from increasing its GVC participation is infrastructure, the derelict quality of its transport systems, and high electricity costs. The Philippines currently ranks 98 out of 144 countries in overall quality of infrastructure, bested by nearly all of its Association of Southeast Asian Nations (ASEAN) neighbors except Viet Nam, Lao PDR, and Myanmar (Navarro 2014). Patalinghug (2015) echoes the importance of flow in every aspect and level of GVC operation, upgrading, and connectivity, and cites Shepherd (2011) to say that the countries that have high costs of transport face comparative disadvantage in world trade.

Another issue is trade barriers in the form of tariff and nontariff barriers that add cost to the product as the latter moves across regional and global chains.

Unlike tariff measures, which usually refer to the taxes placed on the country's exports and imports, nontariff measures are policies and means to comply with certain laws, standards, and regulations of the exporting and importing countries. Health and safety standards and policies that ensure quality control are examples of nontariff measures. However, some measures could act as barriers that increase the costs of doing trade. Nontariff measures have begun to replace tariff measures as a means to protect domestic industries.

Nontariff measures are currently being addressed by harmonizing product and services standards across the region (Llanto et al. 2015). Instead of the varied laws, standards, and regulations present in individual member-states, the ASEAN is obliging its member-states under the AEC to conform to mutually agreed standards and to reduce regulatory burdens.

Part of enhancing the ease of doing business requires addressing regulatory failures (Llanto 2015). The quality of regulations has to be prioritized by identifying regulations that facilitate business and competition, and reforming those that hinder. The National Economic and Development Authority is planning to set up a regulatory impact analysis office to institutionalize the timely evaluation and improvement of regulations in various agencies.

Lastly, competitive services are essential to GVC participation and upgrading. In this regard, Serafica (2015) designed a framework for the national government to identify the necessary conditions for the transformation of various sectors of the national economy to assist local services firms become more competitive and to succeed internationally. Investing in human capital, removing restrictions in services trade, and improving digital infrastructure are some of the elements of a comprehensive framework.

### Conclusion

Developing countries like the Philippines have immense potential to gain and to contribute to value chains and trade networks. Given that GVCs are evident paths for an increasingly more inclusive global economy, it is to the interest of the country to create an enabling trade and business environment.

Government, business firms, and related sectors need to change the way they look at trade (Cattaneo et al. 2013). More importantly, leaders and policymakers must focus on capitalizing on the country's core

competencies and talent—its human capital—and on creating the right environment that is conducive to capturing value chains and to enabling the participating local firms to access higher value-added segments in the chains. \*

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