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Participating in the Global Value Chain: How Low-Income Countries can Maximise the Potential Benefits

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Participating in the Global Value Chains: How Low-Income Countries can Maximize the Potential Benefits[1]

The share of global value added trade secured by developing economies is increasing rapidly – it has grown from about 20 per cent in 1990, to 30 per cent in 2000, to over 40 per cent in 2010. As a group, developing and transition economies are increasingly participating in GVCs, albeit to different degrees and at various levels and stages in the value chain. This is driven by a trend where developed economies now rely increasingly on imported content for their exports, allowing developing countries to add excessively to their domestic value added in exports.

The development contribution of GVCs can be significant – in developing countries, value added trade contributes close to 30 per cent of countries' GDP on average, as compared with 18 per cent in developed countries. They also lead to employment, income and exports. Moreover, they can be an important avenue for developing countries to build productive capacity, primarily through technology dissemination and skill building, thus opening up opportunities for longer-term industrial upgrading.

However, none of these benefits are automatic, and many low-income countries can remain trapped in low-value activities, unable to upgrade and capture more value for economic development. GVC participation can also bring about negative social and environmental effects, including on wages and working conditions, on safety and health issues for workers, on the community, on emissions and others.

While whether or not to actively promote GVC participation is an important decision policymakers have to make, for many low-income countries, the question is less *whether* to promote GVC participation, but rather *how* to gain access to GVCs, maximize the benefits from participation, minimize the risks and upgrade in GVCs.[2]

It is clear that for low-income countries, fostering the building of a complete value chain is a huge task. However, even where this is not possible, governments can still encourage firms to join an existing GVC, which may have low entry barriers and enable firms to realize export success relatively quickly and at low cost. In fact, this can provide increased opportunities: rather than being obliged to

[1] These points have been borrowed from UNCTAD's World Investment Report 2013 and an OECD, WTO and UNCTAD joint publication on Global Value Chains.
[2]For the majority of smaller developing economies with limited resource endowments, there is often little alternative to development strategies that incorporate a degree of participation in GVCs.

develop vertically integrated industries (producing both intermediates and final products), firms can become export competitive by specializing in specific activities and tasks. For example, China specialized in the assembly of final products in the electronics industry and has become the largest exporter of ICT products; other countries specialized in the assembly of intermediates (e.g. sub-systems for motor vehicles in Mexico), the production of parts and components, or ICT services, e.g. India. The experience of a number of emerging economies demonstrates that this engagement in GVCs can offer a fast track to development and industrialization.

Gaining access to GVCs, benefiting from GVC participation and realizing upgrading opportunities in GVCs requires a structured approach that includes, firstly:

<u>Embedding GVCs in overall development strategies and industrial development policies</u>

GVCs require a new approach to industrial development, one based on new markets, new products and new skills. In particular, GVC-based industrial development policies require a shift away from traditional industrial policies aimed at developing production capacity for final goods and services, as improvements in competitiveness are more likely to arise from upgrading to higher value tasks within industries rather than from the development of integrated industries.

GVCs also increase the need for development strategies to incorporate policies dealing with the middle-income trap. The fragmentation of industries increases the risk of “thin” industrialization, where a country enters an industry, but only in its low-value and low-skill aspects – such as assembly of electronics products or call centres in the services sector – without the ability to upgrade. Although countries can also get stuck producing low value added final goods, in GVCs the risk of getting stuck in low-value added tasks and activities could be greater.

However, it is important to recognize that the particular situation and development objectives of an economy need to be taken account of as an integral part of any strategy. What is needed is a tailored approach including country-specific strategies, depending on the different constraints and challenges each country faces.

It is nevertheless clear that any tailored approach can draw to a significant extent from several broad areas that require specific attention:

1. Maintaining an environment conducive to investment and trade and putting in place infrastructural prerequisites

Low-income countries will need to consider how they can open to foreign trade and investment, strengthen trade facilitating measures and reform the business environment as core components of any strategy to participate in GVCs. In addition, improving public governance, the tax system, the corporate governance framework, labour market regulation and intellectual property rights is important. Putting in place the infrastructural prerequisites for GVC participation (e.g. roads, ports, airports, telecommunications, broadband connectivity) is also key. This is an area where developing countries, particularly LDCs, face considerable challenges including in terms of mobilizing foreign and domestic financial resources.

2. Building productive capacities in local firms

GVC participation requires the prior build-up of a minimum level of productive capacity in order to step into the first phase on a GVC. Subsequently, moving up a value chain requires an expanding set of skills and capabilities in upgrading along the value chain, by developing the capabilities of local firms and of the local workforce. Without sufficient investment in skills, economies cannot keep up with technological progress or compete in an increasingly knowledge-based global economy that is essential for GVC participation, especially at higher levels.

A number of focus areas are crucial for proactive enterprise development policies in support of GVC participation and upgrading, including enterprise clustering, linkages development, science and technology support and an effective IP rights framework, business development services, entrepreneurship promotion, and access to finance for SMEs.

In terms of building workforce skills, it is important to first gain a thorough understanding of the economy's position in GVCs and the most likely route of upgrading, which will determine skill requirements. Skill development strategies should also recognize the rising importance of training to comply with product and process standards and internationally recognized certifications. International partnerships, primarily through FDI and joint ventures also play a crucial role in GVC skill strategies by facilitating technology transfer and strict enforcement of skill requirements and product quality by lead firms. Lastly, the continuous maintenance and upgrading of skills is needed, given that skills can become outdated as skill requirements evolve and individuals lose the skills they do not use.

UNCTAD further proposes three specific initiatives:

3. Synergistic trade and investment policies and institutions

Trade and investment policies often work independently of each other, which, in the context of GVCs can have unintended and counterproductive reciprocal effects. To avoid this, policymakers should carefully review those policy instruments that simultaneously affect investment and trade in GVCs; i.e. trade measures affecting investment and investment measures affecting trade. Furthermore, at the institutional level, the trade and investment links in GVCs call for closer coordination and collaboration between trade and investment promotion agencies.

4. "Regional industrial development compacts"

The relevance of regional value chains underscores the importance of regional cooperation. Regional industrial development compacts could encompass integrated regional trade and investment agreements focusing on liberalization and facilitation, and establishing joint trade and investment promotion mechanisms and institutions. They could also aim to create cross-border industrial clusters through joint financing for GVC-enabling infrastructure and joint productive capacity-building. Such compacts could be initiated under already existing bilateral and regional trade agreements and requires working in partnership between governments in the region, between governments and international organizations, and between the public and private sectors.

5. Sustainable export processing zones (EPZs)

Sustainability is becoming an important factor for attracting GVC activities. EPZs have become significant GVC hubs by offering benefits to MNEs and suppliers in GVCs. They could also offer expanded support services for corporate social responsibility (CSR) efforts to become catalysts for CSR implementation. Policymakers could consider setting up relevant services, including technical assistance for certification and reporting, support on occupational safety and health issues, and recycling or alternative energy facilities, transforming EPZs into centres of excellence for sustainable business. International organizations can help through the establishment of benchmarks, exchanges of best practices and capacity-building programmes.

Case Study: Sri Lanka's apparel industry[3]

Sri Lanka's apparel industry provides a good example of an industry that has been successful in maximizing the benefits of GVC participation by moving up the apparel GVC through industrial upgrading. A key driving force behind this industry's trajectory was the abolition of the Multi-Fibre

[3]Adapted from Athukorala, Prema-chandra and Raveen Ekanayake. 2014. *Repositioning in the Global Apparel Value Chain in the Post-MFA Era: Strategic Issues and Evidence from Sri Lanka*, Unpublished Draft.

Arrangement (MFA) in 2005,[4] which, up until then, had provided secured market access for Sri Lanka's apparel exports. The loss of guaranteed export quotas gave way to intensified competition, which, in turn, triggered numerous innovations in the apparel industry, thereby facilitating a high level of GVC participation. As will be discussed, Sri Lanka's success in linking on to the apparel GVC can be attributed to the adoption of many of the policy actions outlined above.

- *Open economic policies*

The boom in Sri Lanka's garment industry started in the period after the late 1970s, led primarily by a conducive policy environment that encouraged GVC participation. The market-oriented open economic policies introduced in 1977 placed greater emphasis on export-led industries[5] and identified the private sector as the engine of growth. The supportive measures taken by the government in this context through the Board of Investment of Sri Lanka, such as duty-free importation of industrial inputs, off-shore borrowing facilities and tax holidays or concessional taxation was another significant contributory factor.

- *Building productive capacity: strong linkages with foreign firms*

At the formative stage, the Sri Lankan apparel industry was very much an integral part of the East Asia centered 'triangular apparel network', where East Asian firms acted as the intermediaries between foreign buyers and the apparel producing firms in Sri Lanka. However, from about the mid-1980s, the importance of triangular trade began to diminish owing to three important developments. First, as the volume of exports expanded, many international buyers began to setup buying offices in Sri Lanka. These buying offices soon began to play a crucial role in linking local firms with international markets. Second, the developed-country (mostly European) firms that had set up operations in Sri Lanka had already established direct market links with retailers in their countries of origin. Third, more recently a number of large local firms have begun to deal directly with lead firms based on market links established with the help of initial joint-venture operations with foreign firms. Some of these firms have set up their own sales offices in major importing countries and in Hong Kong.

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[4] The Multi Fibre Arrangement (MFA) governed world trade in textiles and garments from 1974 through 2004, imposing quotas on the amount developing countries could export to developed countries. The MFA was introduced in 1974 as a short-term measure intended to allow developed countries to adjust to imports from the developing world.

[5] Reforms which placed emphasis on export-led industries extended various measures of support to the sector, such as subsidies and duty rebate schemes, duty-free imports of machinery and raw materials and lower corporate taxes including tax holidays etc.

The type of international buyers who came to the country had a significant implication for the evolution and upgrading of the industry. Mass retailers (Wal-Mart, K-mart, Target etc.) never came to Sri Lanka because the MFA quota allocation systems (which were largely based on the country size) did not allow enough quotas for a given producer to achieve scale economies needed to be a competitive supplier.[6] So from the beginning Sri Lankan exports were predominantly to specialty retailers and brand marketers such as Mark & Spenser, JC Penny, and The Limited. These buyers sought greater variety and placed smaller orders that suit the small scale operation of Sri Lankan firms. And they, unlike the buyers for mass retailers, often worked closely with local manufactures, imparting technical and managerial and marketing knowhow required for product improvement.

The close links forged with brand marketers set the stage for a compositional change in the product mix from mass-market products to niche products, particularly women's underwear and bras, knitted intimate apparel and active wear. Some buyers of brand marketers made even a greater impact on upgrading local firms by becoming joint-venture partners in manufacturing. Among them, the role of Mast Industries, the overseas buying arm of The Limited deserves particular attention. In the mid-1980s Mast set up joint ventures with two small local companies in Sri Lanka to produce intimate apparel (panties and brassiere) and casual wear. With marketing and technical knowhow obtained from this vital initial link, these two apparel firms (later renamed MAS Holdings and Brandix) have grown to become not only the two largest apparel exporters in the country; they have also become multinationals on their own right with production operations in a number of other countries.

- *Industrial upgrading: moving up the value chain*

The building up of productive capacity facilitated an impressive move along the value chain. The apparel industry in Sri Lanka, as in the other second-tier exporting countries, started with 'cut, make and trim' (CMT) operations: simple 'contract manufacturing' using designs and all inputs (fabrics and accessories) provided by the buyer.[7] The industry was also heavily dependent on textile technicians imported from Hong Kong.

[6] For instance, Epic, a Hong Kong based supplier of trousers to mass retailers came to Sri Lanka in early 1990s, but soon left for Bangladesh because under the 'the complex web of quotas that dominated international trade in garments   [it] could not get enough quota allocation to make one product' [trousers] in the tinny country' (Jacob 2013).

[7] In its application to the global apparel industry, the GVC framework specifies four sequential phases in the process of industrial upgrading: cut, make, and trim (CMT) (simple assembly); Original equipment

From about the late-1990s, an increasing number of firms embarked on package contracting (original equipment manufacturing, OEM), which involves sourcing of fabrics and other inputs, producing according to customer specifications. A number of these firms have now become full package manufacturers (or original design manufacturers (ODM)). They offer a full range of services to customers, product development, pattern making, finishing, sourcing, manufacturing and delivery. According to tentative estimates provided by the Joint Apparel Association Forum (JAAF)[8], ODM firms now account for about 60% of total exports (by value), with the rest coming from package contractors. CTM activity has virtually become a relic of the past. There has also been one successful case of a Sri Lankan firm (MAS holding, the largest Sri Lankan apparel firm) launching its own brand, a sign of graduating to original brand manufacturing (OBM) status, the highest stage of the apparel GVC.

Accordingly, by the late 1990s, the Sri Lankan apparel industry had a well-developed customer base including well-known brand names such as Victoria's Secret, Marks and Spencer, Sanisbury's, Tesco, Humkemoller, Abercrombie and Fitch, GAP, Liz Claiborne, Nike, Pierre Cardin, Ralph Lauren, Tommy Hilfiger. Large apparel firms (at least the top ten companies) had established their own design centres which work closely with design teams of brand owners. Most large companies have invested in Computer Aided Designing (CAD) and Computer Aided Manufacturing (CAM), and electronic fitting ('e-fitting'), which enable design decisions by visualizing the garment digitally, skipping the standard fit-on session with a model. They have also invested in supply chain enabling technologies such as enterprise resource planning (ERP), a computer system that integrates all data and processes of an organization into a unified system (a unified database to store data for various functions throughout the organization).

- *Skill upgrading*

Sri Lanka's track record of technical and tertiary education is not as impressive as the country's long-standing success with primary and secondary education. But the country did have a human capital

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manufacturing (OEM) (package contracting); Original design manufacturing (ODM) (full-packaging); and original brand manufacturing (OBM). Moving from CMT to OBM is considered the major upgrading challenge faced by a firm in the apparel value chain. This upgrading trajectory involves acquiring an expanding set of capabilities in filling orders placed by the lead firms, which includes making samples, procuring or manufacturing the needed inputs, meeting international standards in terms of price, quality and delivery, and finally packing and shipping the finished goods.

[8] The Joint Apparel Association Forum is the apex body for all textile and apparel-related associations in Sri Lanka.

base capable of acquiring technical and managerial skills within a short period once the liberalization reforms set the stage for the expansion of the apparel industry. There has been a notable improvement in managerial and technical capability of the apparel industry over the past four decades, with public-private partnership playing a pivotal role. The University of Moratuwa (the main technical university in the country) has been offering (since 1984)a diploma-level design courses in textile technology in collaboration with the London School of Fashion Design. In 2004 the university started offering a four-year degree course in fashion development jointly with North Carolina State University College of Textiles. The JAAF played an important role in initiating this program. JAAF has also taken an initiative to offer a post graduate diploma in Marketing in collaboration with the Chartered Institute of Marketing in UK. Brandix, the second largest apparel producer is running its own training institution, Brandix Clothing Training Institution (BCTI), since 1998. Recently BCTI started offering a master's program in textile technology in collaboration with the RMIT University in Melbourne.

Thanks to these initiatives, the dependence of the Sri Lankan apparel industry on foreign textile technicians (mostly from Hong Kong) has virtually disappeared and Sri Lanka has,in fact,becomea supplier of textile technicians and managers to the other apparel producing countries in the region and beyond.

- *Corporate social responsibility*

The labour market in Sri Lanka requires strict compliance of several labour-related regulations which are rigorously enforced and monitored by the labour department and other bodies.[9]These initial labour market conditions were instrumental in preparing the apparel industry to effectively face the 'ethical trade' norms which the international buyers have recently begun to emphasize as an important part of their procurement policy.

Against this background, the upward movement in the value ladder of Sri Lankan apparel producers has been accompanied by a greater emphasis on ethical employmentpractices than in many of its Asian competitors. In this respect, MAS Holdings took the leadin the mid-1980s as part of its emerging role as a major supplier to Victoria's Secret.Following MAS's lead, the other apparel manufacturing firms also have established their own corporate social responsibility programsfor employees.Most firms provide workers with transport facilities, free breakfast, subsidized meals and

[9] These include minimum wage legislation, restrictions on labour retrenchment and severance payments, trade union activism and the 39 ILO Core Convention covering workplace practices, prohibition of forced labour, child labour and ensuring better working conditions.

medical care. They also actively engage in community services in rural area where the factories are located. The 'Garment Without Guilt 'campaign launched by JAAFhas played a pivotal role in strengthening CSR commitments among apparel exporting firms and promoting Sri Lanka's name as an ethical clothing manufacturer.

Some apparel factories in Sri Lanka have started to produce 'fair trade' clothing, clothing made out of organic and fair-trade cotton imported from India and some African countries. The three largest firms already supply organic cotton clothing for brand names such as Mark & Spencer and Tesco[10]. Some local fabric producing companies have obtained fair-trade and organic accreditation from international certification bodies such as FLO-Cert GmbH in Germany and Institute of Market-ecology (IMO) in Switzerland. With increasing global concerns regarding climate change, a number of apparel firms have started investing in building 'green factories', which meet the international environmental standards.

It can thus be seen that Sri Lanka has emerged as a successful participant in the global apparel value chain in spite of the loss of guaranteed market access provided by export quotas. While foreign buyers played an essential role in linking Sri Lankan firms to the GVC, a domestic enabling environment, including a highly skilled domestic workforce, an entrepreneurial class, proactive industry associations, and most importantly, the policy reforms in 1977 that removed many barriers to trade and investment, was also of immense importance. In addition, collaborative actions by the industry and the government greatly eased the burden of adjustment to the abolition of MFA quotas, and helped utilize the opportunities that arose in the post-MFA environment.

[10] Tesco sells clothing designed by Katherine Hammett, a designer known for her political t-shirts and her ethical business philosophy.