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More than T-shirts: the Integration of Developing Country Producers in Global Value Chains

(based on *Business for Development 2007*)

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- Technological change and organisational advancements have made possible the greater participation of developing country producers in international trade, in a wide range of goods and services.
- However, firms based in industrial countries often determine the scope for insertion and upgrading of those producers in global value chains (GVCs).
- Companies are most likely to succeed when they treat global competition as an opportunity to link up to strategic players, learn and build capabilities.

A global factory?

It is difficult to think of a product, even a very sophisticated one such as an i-Pod, an aircraft or a Formula 1 car, that does not contain at least some components produced in a developing country. Even products that require precision manufacturing, like hard disk drives and many kinds of semiconductors, are becoming "high-tech commodities" made in production facilities in Southeast Asia and elsewhere.

International production sharing *per se* is not new, however. What is new is its scope and governance structure. Production sharing between developing and industrial countries emerged in the mid-1960s when large, vertically integrated multinational enterprises (MNEs) established subsidiaries in developing countries and transferred there their labour-intensive production activities (e.g. electronics and semi-conductors, apparel and leather goods). The main objective was to exploit lower labour costs and preferential market access to industrialised countries (e.g. through outward processing arrangements). The scope of such triangular manufacturing expanded with the reduction in trade and transport barriers in the late 1980s, as well as the improvement of suppliers' capabilities, technological progress and new organisational practices (e.g. flexible manufacturing and modular product architectures). The transformation of retailing in industrialised economies, especially the United States, was also a major driver behind the industrial restructuring and upgrading in many Southeast Asian countries.

These developments multiplied developing countries' links with global value chains (GVCs) for a wide range of products and contributed to a further transformation from the earlier "vertical integration" model of production to "vertical specialisation"[1].

What impact on developing countries?

International trade and investment have been formidable vehicles of knowledge diffusion and development. Developing countries have substantially increased their share in international trade in parts and components,

1. A value chain describes the interrelation of economic activities within a firm, where value is added at each stage of production. A value or production network is a network of several interrelated value chains, spanning upstream suppliers and downstream customers across sectors, providing services and other inputs. A global value chain is a network of value chains that involves several actors in different locations, spanning over many countries.

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accounting for 35 per cent of world exports and 44 per cent of imports in the late 1990s. Producers, originally confined to assembly tasks, have developed own manufacturing capabilities and taken more and more responsibilities, from procurement to logistics, up to contributing to the product's design for branded-retailers ("manufacturers without factories"), sometimes even developing own-brands. In growing instances, developing country subcontractors working for OECD MNEs, have become MNEs themselves, as witnessed by expanding outward foreign direct investment (FDI) flows from developing countries.

But this positive picture needs qualifying, as outcomes of expanded trade and investment have not been uniform across countries or industries. Firms based in industrial countries retain control on key proprietary assets such as technological, organisational and marketing skills, as well as brand-name and design. GVC leadership is still exercised by MNEs, buyers or global retailers that often only transfer to their suppliers in developing countries the necessary know-how to perform simple assembly work. Moreover, while buyers concentrated (and thus acquired stronger bargaining power), the pool of potential suppliers has enlarged. Hence depressed export prices and profit margins for these suppliers.

Evidence from selected industries

The OECD Development Centre *Business for Development 2007* analyses opportunities for developing-country firms to participate in several GVCs, not only in traditional labour-intensive manufacturing, but also in more hightech industries and in services. Industries considered include household appliances (in China, Mexico and Turkey), animation (in the Philippines), tourism (in Mozambique) and aircraft (in China). These industries are all characterised by an ongoing fragmentation of supply that involve more and more developing-country producers or providers.

The case studies suggest that participation to GVC creates opportunities for developing-country firms to expand and upgrade their production capacity. Trade integration has driven the dramatic expansion of white goods exports from Mexico to the US and from Turkey to Europe. Companies from these countries started as Original Equipment Manufacturers (OEM) suppliers and then successfully established themselves as strong regional players, including through outward FDI. The prospects of liberalisation of civil aviation have boosted production of regional jets in Brazil and now in China. Hanna-Barbara, Toei, and Warner Brothers have been producing Western animation and Japanese *anime* in the Philippines since the early 1990s. Improvements in ICT and computer graphics are likely to lead to further outsourcing of animation services, creating new opportunities but also challenges for animation studios in the Philippines which have specialised in mechanical work rather than developing creative skills. The expansion and transformation of international tourism is bringing new investments and people to countries insofar excluded from the map of world travellers, including Mozambique. Although tourism has become a global value chain, where MNEs such as airlines, tour operators and hotel management companies play a decisive governing role, the tourist experience is very much tied to the local amenities and existence of complementary services. Inadequate institutional support in "branding", barriers to acquiring intermediary inputs and bureaucratic hurdles undermine the competitiveness of the Mozambican travel and hospitality industry.

Reaping the full benefits of globalisation

Companies are most likely to succeed when they treat global competition as an opportunity to link up to strategic players, learn and leverage on these partnerships to build capabilities, move into more profitable industry segments, and adopt strategies that turn latecomer status into a source of competitive advantage.

Success depends on firms' internal resources as much as it does on the collective efficiency of the cluster in which they operate. The choice of off-shoring locations is driven not only by demand and cost considerations, but also by the presence of suppliers of specialised components and services and the quality of public goods provided by host countries. Policy continues to play an important role in attracting foreign investment and promoting linkages with domestic companies. But governments must not substitute for markets nor indulge in picking winners, as such interventions often perpetuate inefficiencies.

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