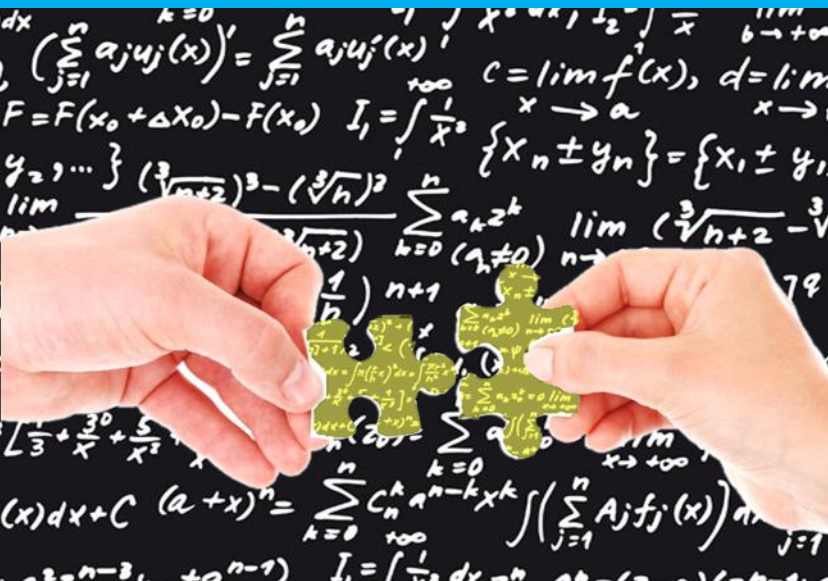




## South-South cooperation in the era of Global Value Chains: What can China offer?



**Shunli Yao**

ASIA-PACIFIC RESEARCH AND TRAINING NETWORK ON TRADE

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## **South-South cooperation in the era of Global Value Chains: What can China offer?<sup>†</sup>**

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## **Abstract**

China is a success story of inclusive trade growth as a result of its participation in Global Value Chains (GVCs). It is in transition from a processing and assembly hub towards an innovation centre, and is becoming a regional supplier of research and development (R&D) intensive parts and components. The infrastructure projects under the Belt and Road Initiative (BRI), a quasi-regional trade arrangement, are helping to improve regional connectivity and production linkage, but Chinese manufacturing also brings shocks to local production and employment. To achieve the full potential for job creation through production linkage with China, as well as to buffer the shocks, BRI countries may consider a special customs regime to help build labour-intensive assembly and processing manufacturing. China's processing trade regime is an innovation in this regard and could be part of the strategy of inclusive trade growth for other developing countries. Inclusive trade is becoming a policy imperative, not only because Governments in BRI countries need popular support for their foreign trade and investment policies, but also because it is in China's interest to establish mutually beneficial GVCs, in order to help lay the political economy foundation for BRI and other initiatives.

**Keywords:** Global Value Chains, South-South cooperation, China

**JEL Codes:** F15, O19, F50

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## Introduction

Since the 1980s, Global Value Chains (GVCs) have become a new feature of international trade (Krugman, 1995). The emergence of this new trade model has changed the way people think about trade policies (Hoekman, 2014). It has also inspired developing countries to restructure their trade cooperation. China is an important GVC player, and the Belt and Road Initiative (BRI) provides an opportunity for China to engage other developing countries in GVC trade to promote inclusive growth.<sup>2</sup> Furthermore, in order to improve the livelihood of the local communities, to steer and organize infrastructure projects along the lines of GVC development could help lay the political economy foundation for the sustainable development of the BRI. This is a new thinking for economic cooperation between China and other developing countries, and could also become an innovative model for South-South trade cooperation.

Except for minerals, agriculture and other primary products, traditionally no distinct overall comparative advantages existed among developing countries in manufacturing. Traditional South-South trade mainly relied on primary industry and products. At the micro level, significant comparative advantages in production techniques and procedures may lead to trade in manufacturing inputs between developing countries; however, such potential has not been fully realized due to high transportation and communications costs. This is one of the reasons why South-South trade remains stagnant, except for trade with China (Aksoy and Ng, 2014).

With the reduction of international communications and transportation costs, production processes can be divided into many separate parts, with each being transferred to different locations of the world for production and assembly. This has led to a substantial increase of global trade and, in particular, China's processing trade in manufacturing. However, developing countries' GVC participation is still limited to the North-South trade model, i.e., technology-intensive components are developed and produced by advanced countries, then assembled in developing countries, and

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<sup>2</sup> In this paper, "BRI countries" or "BRI regions" refer to the geographical areas covered by, or broadly related to this development cooperation initiative, but do not necessarily imply endorsement of it by concerned national governments.

finally sold back to home countries or to other markets around the world. As far as South-South manufacturing trade is concerned, there has been no structural change other than taking part in GVC trade with China – which, in turn, is involved in North-South value chains trade and has experienced rapid growth of manufacturing exports. This has created shocks in other developing countries with fragile manufacturing sectors. As a result, the South (China)-South trade imbalance deteriorates.

Needless to say, the problems in South-South trade have much to do with poor infrastructure and weak trade governance capacity on the part of developing countries. However, the supply-side bottlenecks are not unique to South-South trade. They are also a constraint on the development of trade relations between some developing countries, and the least developed and developed countries. Today, with ever-closer South-South cooperation, mainly in non-trade areas, developing countries have more opportunities to trade among themselves. Emerging markets, the bright spots in the developing world with ever-stronger trade complementarity, are potential export destinations, sources of foreign direct investment (FDI) and industry transfer for other developing countries.

The root cause of the problems in South-South trade is: (a) the lack of full appreciation of the successful experiences of the North-South value chains trade; and (b) the lack of a clear strategy and a coherent policy package. This does not allow to translate these opportunities into inclusive trade growth and job creation in developing countries, to ultimately achieve poverty reduction and other development objectives. The opportunities are real, particularly in China's economic and trade cooperation with other developing countries. Against the backdrop of China's success, this paper closely examines the problems in South-South trade and offers policy recommendations.

The BRI provides an important chance to reshape South-South trade relations, among others. Infrastructure investment in roads, ports and communications will certainly reduce transportation costs and facilitate the movement of people. Consequently, this will enable firms to better arrange and coordinate production and division of labour across a broader region. It is the shared hope of the people in the BRI region that it will lead to development of labour-intensive manufacturing, increased employment

opportunities and improved income distribution through closer connectivity with China. Chinese manufacturing comprises both emerging high-tech industries and traditional labour-intensive industries; therefore, trade relations between China and other developing countries can be both complementary and competitive. On the other hand, in countries where the system of popular election has been adopted, people affected by imports tend to vote for political parties that are against open trade, thereby slowing or even reversing the trade liberalization process.

The outcome of the United States' 2016 presidential election is an example. A similar scenario could also occur in BRI countries, as most of them are democracies with a "one person, one vote" election system, under which trade shocks can induce political repercussions. The political inclination of workers in labour-intensive manufacturing industries cannot be ignored, as they are often a key constituency that nationalist and populist politicians are keen to woo in times of economic difficulties. Therefore, for China to take the GVC opportunity to tap the potentials of economic complementarity, while minimizing competition shocks to neighbouring countries, would be helpful not only in balancing manufacturing trade, but also in securing broad and sustainable public support for the BRI.

This paper is organized as follows. Section 1 explains the importance for China to properly handle its offensive interests in market access in BRI development. Section 2 analyses the status of value chain integration between China and other BRI countries. It then evaluates bilateral trade policies, with a focus on pressing issues, such as the flood of China's manufacturing exports and the resulting political repercussions in BRI countries. With a view to solving these problems and ensuring steady and sustainable BRI development, section 3 discusses China's successful

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