

## EXECUTIVE SUMMARY

### Global value chains and globalisation

The pace and scale of today's globalisation is without precedent and is associated with the rapid emergence of global value chains as production processes have become more geographically fragmented. Globalisation also increasingly involves foreign direct investment (FDI) and trade in services, as many service activities are becoming internationalised. Another distinctive feature of the current process of economic integration is that it is no longer restricted to OECD countries, but also involves large emerging global players such as China, India, Brazil and Russia.

The globalisation of value chains is motivated by a number of factors, of which enhancing efficiency is the most important. One way of achieving that goal is to source inputs from more cost-efficient producers, either domestically or internationally and either within or beyond the boundaries of the firm. Fragmentation of the production process has given rise to considerable restructuring in firms, including the outsourcing and offshoring of certain functions. The growth of international sourcing has also resulted in the relocation of activities abroad, sometimes involving total or partial closure of production in the home country and the creation of new affiliates abroad.

### International sourcing

Trade in intermediates is growing and domestic production increasingly relies on foreign inputs. In 2003, 54% of the world's manufactured imports were classified as intermediate goods (these include primary goods, parts and components, and semi-finished goods). As a result of the growing global linkages between countries, a decreasing share of production takes place within national boundaries.

High- and medium-high technology industries are on average more internationalised than less technology-intensive industries. Rapid advances in information and communication technologies (ICT) have increased the tradability of many service activities and created new kinds of tradable services thereby facilitating the sourcing of services from abroad. Although the level of international outsourcing is still much lower in market services than in the manufacturing sector, imported intermediates in services sectors have become more important.

## The key role of multinationals

Within global value chains, multinational firms play a prominent role, as their global reach allows them to co-ordinate production and distribution across many countries and shift their activities according to changing demand and cost conditions. Cross-border trade between MNEs and their affiliates, often referred to as intra-firm trade, accounts for a large share of international trade in goods. The development of global value chains also offers SMEs new opportunities by enabling them to expand their business opportunities across borders, although they often face difficulties in reaching international markets.

## New centres of economic growth

Although OECD countries still dominate, manufacturing production in certain non-OECD countries has increased significantly and is expected to grow further in the near future. China, in particular, has become a major trading partner for most OECD countries and its market share in OECD export markets has risen significantly. Trade and FDI are still largely concentrated within industrialised countries, suggesting that the globalisation of value chains is not primarily a North-South issue. Globalisation is a two-way process, with trade and FDI between OECD and non-OECD countries flowing in both directions.

## The employment effects of globalisation

Offshoring and especially relocation are often perceived as the “exporting of jobs” which directly results in a loss to the country and its workers. The globalisation of value chains affects economic performance in various ways, however, including employment, productivity growth, prices and wages, and these impacts vary across activities, regions and social groups. In general, the process of globalisation has both benefits and costs, some dispersed and some concentrated, some short-term and some long-term. The visible, short-term costs often attract the most attention, as these are more easily measured, while the long-term benefits may be much harder to calculate.

Several studies that provide estimates of the jobs (potentially) lost due to offshoring find a large absolute number of jobs lost because of offshoring, but a relatively small impact when compared with overall churning in the labour market. Furthermore, some of these jobs may have been lost owing to productivity enhancements and technological change, which are not necessarily linked to offshoring.

The long-term effect of globalisation primarily seem to involve the composition, rather than the level, of employment. Trade integration leads to changes in the international division of labour, resulting in employment losses in certain industries (*e.g.* manufacturing). Certain regions, sectors and groups of workers may lose out in this process, *e.g.* those in industries heavily exposed to international competition which have not been able to adjust to that competition. In OECD countries, globalisation is found to have disproportionate impacts on certain types of workers, particularly low-skilled workers who may also be concentrated in certain regions.

## The productivity benefits of globalisation

Openness to trade and FDI raises productivity and hence average incomes and wages. Gains from trade typically arise from the exploitation of comparative advantages and economies of scale. At the same time, trade generally results in lower prices for imported goods and services (both final and intermediate) and increases product variety and quality in the home country. In addition, operating in a globally competitive market may force firms to become more engaged in innovative activities and globalisation offers an important channel for flows of foreign technology that embody significant innovations.

MNEs contribute significantly to productivity, but the productivity effects of globalisation diffuse beyond them. Their key role in the current globalisation process may be to generate additional positive effects on host countries' economies because of their typically superior performance. The inflow of FDI may spur domestic competition and result eventually in higher productivity, lower prices and more efficient resource allocation in host countries. Technology and knowledge may also spill over from foreign affiliates to domestic firms in host countries through the many interactions between them. MNEs are not the only firms to benefit from internationalisation. Internationally active firms, because they export or import and/or have affiliates abroad, tend to have higher productivity. Exports and direct investment abroad may provide helpful feedback to firms which can help them to improve productivity.

## Structural change towards a knowledge economy

The integration of new players in the global economy challenges existing comparative advantages and the competitiveness of countries, forcing them to search for new activities in which they can excel and confront the competition. The key drive is for countries to move up the value chain and become more specialised in knowledge-intensive, high-value-added activities. Specialisation in more traditional cost-based industries and activities is often no longer a viable option for most industrialised countries. The manufacturing sector is most strongly affected and the process is accompanied by de-industrialisation in most OECD countries, driven by rapid changes in productivity in the manufacturing sector and a shift in demand to services. Investment in knowledge is crucial for sustained economic growth, job creation and improved living standards and has increased in all OECD countries in recent years. At the same time, most OECD countries are shifting into higher-technology-intensive manufacturing industries and into knowledge-intensive market services. A considerable number of OECD countries still have a strong comparative advantage in medium-low-technology and low-technology industries.

Some non-OECD economies are moving up the value chain: China has diversified from traditional industries into higher-technology-intensive industries. The strong growth of Chinese exports of more sophisticated electronics, furniture and transport goods is closely linked to China's growing imports of parts and components. An important question is whether China is merely assembling component parts or whether there are indications that the country has increased value added in higher-value-added ICT goods. China's trade surplus is not due to high-technology exports, but to large exports of lower-technology industries such as toys, textiles and footwear.

MNEs' R&D investment abroad has grown strongly as their strategies focus on global technology sourcing. This involves building global networks of distributed R&D in order to tap into local knowledge and develop sources of new technology. While most internationalisation of R&D still takes place within the OECD area, large increases in foreign R&D investment in Asia, in particular in China and India, have attracted much attention in recent years. This should be seen as an opportunity, as increased international R&D links can promote faster technological change and broader diffusion of technological advances worldwide.

## Policy implications

Moving up the value chain implies a continuous process of change, innovation and productivity growth. Industrialised economies can only grow by inventing new technology, by innovations in products and processes, and by designing new management methods. To foster and support the innovation process, a strategy for innovation has to be developed in which several policy areas may be considered:

- Innovation policies help increase the level of knowledge and technology embodied in production and exports. Policies aimed at strengthening creativity in business or on developing intangible assets as sources of value creation are closely related to these policies.
- A more innovative and productive economy may require more highly skilled workers or a different mix of skills. Addressing this through education and training policies requires a growing focus on lifelong learning.
- Policies might also aim at creating new areas of economic activity, by stimulating new firm creation and entrepreneurship, or by stimulating innovation and technology in new areas.
- International and local firms may be attracted to specific activities and skills which exist only in certain regions or locations. Policies aimed at the development of clusters and poles of excellence as well as regional policies may help capitalise on countries' strengths.
- Understanding what determines national attractiveness, building on national strengths and addressing weaknesses to the extent possible can help extract greater benefits from the globalisation process.
- Striking an appropriate balance between diffusion of technology and providing incentives for innovation remains an important consideration in IPR-related policies. Moreover, more can be done to generate value from IPR, *e.g.* through licensing.
- In several OECD countries, the current policy debate looks at possible actions which the government may undertake to strengthen firms' capacity to compete in the global market and which complement efforts towards well-functioning and competitive markets. Such actions include the innovation and entrepreneurship policies that have become the core of industrial policy in the 21<sup>st</sup> century.

If countries are to realise the potential gains from openness, the factors of production (including labour) must shift from economic activities in which they are relatively less efficiently used towards activities in which the economy enjoys a comparative advantage. However, it can be hard for individuals to move between jobs, industries and regions, and workers losing jobs in firms in import-competing industries sometimes bear large adjustment costs; hence the need for complementary structural policies to help workers reallocate from lagging to more advanced industries and for policies to compensate potential short-term losers from globalisation. Although globalisation benefits economies as a whole, the gains are unevenly distributed. Providing a balanced perspective on the benefits and costs of globalisation can help. The problem is that globalisation may generate highly visible costs for clearly identifiable groups of people, while some benefits may only come later and are widely diffused across society. A promising avenue may be to address more directly the costs of globalisation by compensating those who may suffer a short-term decline in income.

There are concerns that globalisation may put some world regions at particular risk of being left behind. Other concerns relating to globalisation are linked to the potential environmental impacts in developing countries. Further trade liberalisation in sectors in which poorer countries have a comparative advantage (especially agriculture), complemented by efforts at capacity building and development policies, may help to spread the benefits of globalisation to a wider range of countries, including those most at risk of being excluded.

Protectionist measures (for example, that insulate countries from the impacts of globalisation through import barriers, that penalise firms that engage in offshoring, and that slow exposure to international competition) are likely to raise costs for firms and reduce their efficiency. This will have a detrimental impact on consumers who buy products from these firms and may also make the countries adopting such policies a less attractive place to do business. Protectionist measures also have detrimental effects on other, often poorer, countries, by denying them the chance to trade and increase living standards.