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South-south cooperation in the era of global value chains: What can China offer?

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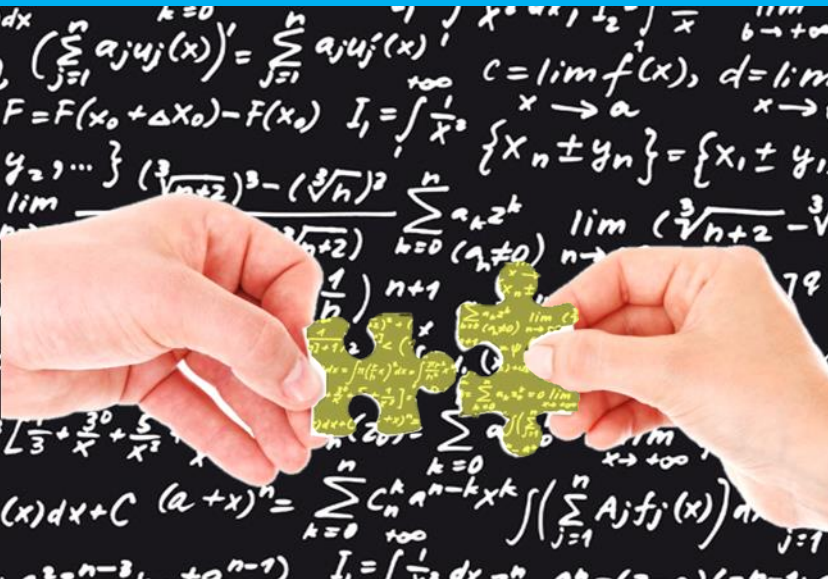
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**South-South
cooperation in the era of
Global Value Chains:
What can China offer?**



Shunli Yao

ASIA-PACIFIC RESEARCH AND TRAINING NETWORK ON TRADE

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ASIA-PACIFIC RESEARCH AND TRAINING NETWORK ON TRADE

WORKING PAPER

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

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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.² 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

² 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 experience with the "processing trade regime", which facilitates its GVCs integration and helps achieve poverty reduction through trade. It also argues for the adoption of similar customs arrangements in other developing countries. Section 4 proposes that China consolidates its regional projects under the framework of the World Trade Organization's "Aid for Trade" (AfT) programme, launched at the 2005 WTO Ministerial Conference in Hong Kong, in order to promote inclusive manufacturing exports in BRI countries. Finally, section 5 summarizes the policy recommendations.

1. Market access in the BRI: Problems and possible solutions

Market access is a major issue in the BRI, which is a quasi-regional trade arrangement. There are two types of market access in regional trade negotiations involving China – one with offensive interests and the other with defensive interests. The former refers to the case when China seeks access to overseas markets, and the latter refers to access to the Chinese market by foreign products. In China's free trade negotiations with developed countries, such as Japan, the Republic of Korea and Australia, market access is mainly China's defensive concern.

However, in regional trade arrangements, for other developing or least developed countries, China's offensive market access becomes the primary concern because they generally lack competitiveness in manufacturing. This is an outstanding problem in the BRI, which, like China's other trade arrangements, is not just an economic initiative. BRI is more of strategic and geopolitical significance, whilst its economic significance is only secondary, as reflected in its shallow economic integration (Gao, 2009). In dealing with the offensive market access issue, export maximization should not be the single policy objective. Rather, it should be coupled with other considerations. Mutually beneficial regional value chains can piece together diverse policy objectives and be an important guiding principle for the BRI.

Depending on their supply chain status with China, the BRI countries can be divided into three groups. The first group is comprised of the countries that have established supply chain relations with China, such as the Association of Southeast Asian Nations (ASEAN). The second group consists of countries that are in the process of establishing a supply chain relationship with China, such as India, Pakistan, Sri Lanka and other South Asian countries. The third group includes African nations and, in a broad sense, the Pacific island countries, that do not have a value chain linkage with China or have one that is still in its infancy. Although different in many aspects, these countries have one thing in common: most of them are democracies, at least nominally, and poverty reduction through inclusive trade growth is a policy priority. BRI regional trade arrangements should be made with consideration being given to these factors.

Specifically, guided by the aid programme that aims to promote trade, China's success story of mass poverty reduction through GVC integration can be introduced to those countries, in order to foster low-risk and sustainable trade and economic relations.

The processing trade regime is the key to China's success in building GVCs. About half of China's foreign trade falls into the processing trade category. Compared with similar processing exports in other countries, the size of China's processing trade is unprecedentedly large. This can be attributed to China's concessionary policies in support of FDI and exports, as well as to institutionalized special customs arrangements. Despite its huge territory, this special customs regime enables China to effectively supervise and facilitate processing trade. This is clearly pointed out by Naughton (1996, p. 302):

“None of these concessions are unique. All are observed elsewhere in East Asia and, indeed, around the globe. The scale on which these provisions were introduced in China, however, is unusual. In most countries, such concessionary provisions are only applicable within a strictly policed export processing zone. In essence, China created a kind of gigantic export processing zone, defined not geographically, but by the juridical status of the enterprise involved. Although the special economic zones (SEZs) attracted a lot of attention and were located near important economic centers in southern coastal China, they did not determine the extent of the export processing regime; export-oriented foreign invested enterprises (FIEs) qualified, whether they were located in SEZs or not.”

In this sense, the processing trade as a customs regime is China's innovation.³ It helps spread labour-intensive assembly and processing across the country, which has the lowest entry threshold for unskilled labour and creates job opportunities for millions of migrant workers from the inland rural areas. China's success story is a good illustration of development through GVCs trade growth inclusive of the country's poor. Lessons of China's success in managing processing trade for BRI countries are elaborated in section three.

³ Mexico is the other one of only two countries in the world that have a special customs regime for managing processing trade.

What are the practical problems for China in the BRI regions? How could China's experience help solve these problems? Considering the specific circumstances of different regions, this paper discusses in further detail the relevant issues with ASEAN, South Asia (India, Pakistan and Sri Lanka), Africa and South Pacific island countries.

2. Building China-BRI value chains: Motivation and challenges

2.1. ASEAN: Changing Asia-Pacific value chains⁴

The Asia-Pacific region has well-developed value chains in which China and ASEAN play a key part. China's manufacturing industries have long engaged in low-end and low value-added exports with thin profit margins. This makes them vulnerable to overseas market downturns. Since the 2008 global financial crisis, China has been trying to make changes to its export strategy. The same policy movement is also occurring in some ASEAN countries.

Economic development across China is uneven. In ASEAN it is not homogeneous either. Table 1 lists the per capita GDP for ASEAN members. It should be noted that although Brunei Darussalam enjoys the second-highest per capita GDP among ASEAN members, its economy is highly dependent on oil production; therefore, its per capita GDP is not a good indicator of the country's real economic and social development level. Except for Brunei Darussalam, in terms of per capita GDP numbers ASEAN members can be divided into three categories – high-income countries (Singapore and Malaysia), mid-income countries (Thailand, Indonesia and the Philippines) and low-income countries (Viet Nam, the Lao People's Democratic Republic, Cambodia and Myanmar).

⁴ This section is drawn from Yao *et al* (2014).

Table 1. ASEAN per capita GDP, selected years in current United States dollars

Country	1997	2000	2003	2006	2009	2012	2013
Brunei Darussalam	16 227	12 751	12 973	31 452	28 454	42 445	39 678
Cambodia	320	293	314	515	735	977	1 047
Indonesia	1 128	731	1 141	1 636	2 362	3 578	3 467
Lao PDR	336	333	364	576	913	1 394	1 505
Malaysia	4 672	3 874	4 150	6 160	7 216	10 338	10 407
Myanmar	100	184	179	233	538	861	916
Philippines	1 157	980	976	1 408	1 829	2 565	2 707
Singapore	25 147	22 757	22 076	33 089	37 961	52 069	55 183
Thailand	2 656	2 026	2 239	3 162	3 947	5 391	5 678
Viet Nam	361	403	487	732	1 129	1 596	1 909

Source: ASEAN Macroeconomic Database.

While Chinese coastal firms are starting parts and components production, the country's inland provinces are welcoming traditional processing and assembly businesses. Similarly, when Singapore and Malaysia see more multinational corporations move in their research and development (R&D) centres (Athukorala, 2013), the low-income ASEAN members are embracing the opportunities offered by the industrial adjustments in China and high-income ASEAN countries. This increasingly finer division of labour within China and ASEAN is reflected in the changing patterns of trade in parts and components in electronics and machinery, and the textile and clothing sectors, as shown in tables 2, 3 and 4. In organizing Comtrade data, the United Nations Broad Economic Categories classification has been used to define parts and components.

Table 2 lists the total value and share of parts and components in China's electronics and machinery imports from high-income and mid-income ASEAN countries during 1997-2013. While the total imports of the products from the two groups of countries are skyrocketing, the shares of parts and components are changing in different directions. As expected, the share of parts in imports from Singapore and Malaysia increased from lower 70s to mid 80s in percentage, up by more than 10 per cent. In contrast, the same share for parts imported from Thailand, Indonesia and the

Philippines declined in trend from 70s to 50s in percentage, down by 20 per cent. Clearly, there is a divergence between the two groups of countries within ASEAN in their roles of production sharing with China in the electronics and machinery sector. In terms of trade and production relations with China, the former group is specializing more towards the production of R&D-intensive parts and components, while the latter group is becoming less so. This pattern suggests that China is adjusting to somewhere between high-income and mid-income ASEAN with regard to its position in global value chains in electronics and machinery sector.

Table 2. Chinese electronics and machinery imports from ASEAN: Total and share of components, 1997-2013

Year	Singapore and Malaysia		Thailand, Indonesia and the Philippines	
	Total (US\$)	Share (%)	Total (US\$)	Share (%)
1997	2 473 665	75	665 924	70
1998	3 162 320	73	1 257 820	81
1999	3 635 103	70	1 813 598	75
2000	5 620 990	71	3 363 350	78
2001	6 347 620	75	3 962 382	80
2002	9 334 555	76	5 867 400	76
2003	14 626 641	73	10 741 213	69
2004	19 667 705	74	15 124 575	69
2005	24 253 822	77	20 794 834	67
2006	26 692 954	78	27 177 642	69
2007	29 013 142	78	35 184 507	71
2008	30 226 313	76	34 522 304	64
2009	29 898 793	79	25 716 588	53
2010	45 693 785	81	32 106 585	56
2011	52 680 807	80	33 687 027	55
2012	50 510 017	82	33 619 388	52
2013	52 100 644	86	28 808 834	60

Source: United Nations COMTRADE.

Table 3 lists China's exports of parts and components to the low-income ASEAN countries (Viet Nam, Lao People's Democratic Republic, Cambodia and Myanmar) in

two sectors, electronics and machinery, and textiles and clothing. Again, trade volumes are skyrocketing, but the share of parts and components exhibit quite different patterns. For electronics and machinery, the share has experienced a sharp jump from merely 14 per cent in 1997 to 51 per cent in 2013, up by 37 per cent.

Table 3. Chinese exports to Viet Nam, Cambodia, Lao People`s Democratic Republic and Myanmar

Year	Electronics and machinery		Textiles and clothing	
	Total (US\$)	Share	Total (US\$)	Share
1997	271 599	14	384 747	58
1998	343 633	19	394 813	53
1999	262 603	19	340 887	66
2000	323 138	25	331 176	88
2001	517 579	34	341 145	91
2002	752 497	39	582 435	85
2003	909 567	39	835 752	83
2004	1 143 743	39	1 077 106	88
2005	1 370 289	36	1 417 777	90
2006	2 026 148	36	1 813 211	92
2007	3 700 063	33	2 546 995	89
2008	5 417 107	33	3 330 831	84
2009	6 318 347	32	3 968 419	73
2010	8 496 394	35	6 325 552	76
2011	10 875 649	37	8 695 420	76
2012	12 657 988	46	11 239 111	62
2013	19 236 707	51	16 090 113	61

Source: United Nations Comtrade.

In the textiles and clothing sector, an upward trend is also shown, although at a more modest pace, rising from 58 per cent in 1997 to 92 per cent in 2006, before starting a decline to reach 61 per cent in 2013. The rise in intermediates exports was the result of the Uruguay Round's decision to abolish the Multi-Fibre Arrangement (MFA) in 2005. When the MFA quota was expanding prior to 2005, China's rising share of parts and components exports to low-income ASEAN members increased. This reflected its

strategy of taking advantage of cheap labour as well as their newly acquired market access to the United States and the European Union, while concentrating its own resources on capital-intensive and high value-added yarn production. After 2005, when the MFA was phased out, the European Union and the United States signed special safeguard treaties with China as a new mechanism to restrict Chinese textiles and clothing exports to those two major markets. In addition, negotiations on the Trans-Pacific Partnership (TPP) Agreement were accelerated. Viet Nam officially joined the TPP negotiations in 2010. Regarding the rules of origin provision on apparel, the United States insisted on the “yarn forward” principle. It was believed that textiles and clothing products containing Chinese yarn would not enjoy market access privileges under TPP. These factors contributed to the decline of the intermediates in terms of share in total textiles and clothing exports after 2006. However, in terms of total volume, exports of intermediates continued to rise steadily over 1997-2013. Certainly, China has been helping set up sewing and assembly businesses in textiles and clothing sector in these countries.

In the case of electronics and machinery parts and components, do any differences exist between China-made products and those made in high-income ASEAN countries? The products from the former source are thought to be less technological sophisticated. To verify this, this study compares the FOB unit value of the goods at 6-digit HS level exported by China to low-income ASEAN countries and the products with the same 6-digit HS codes exported by Singapore and Malaysia to China during 1997-2013. Table 4 shows the result as well as the number of compared products. Indeed, Chinese unit values are consistently lower than those for the same products made by high-income ASEAN countries. This is reflected in the share of products with a ratio of less than 1, ranging from the lowest (69 per cent), to the highest (88 per cent). On average, during 1997-2013, China had a lower unit value for 81 per cent of the common products in the category of electronics and machinery parts and components.

Table 4. Price comparison: Electronic and machinery parts, China-made / high-income ASEAN-made

Year	Number of common HS6	Number of HS6 w/ price ratio <1	Share of HS6 w/ lower price
1997	118	92	78
1998	138	113	82
1999	134	93	69
2000	191	164	86
2001	202	168	83
2002	223	185	83
2003	229	185	81
2004	227	179	79
2005	222	177	80
2006	227	187	82
2007	211	171	81
2008	221	186	84
2009	213	154	72
2010	218	173	79
2011	224	198	88
2012	201	168	84
2013	155	136	88
Average			81

Source: Author's calculation based on United Nations Comtrade FOB data.

Electronics and machinery, and textiles and clothing are the two most outsourced sectors. Changing trade patterns in parts and components for the two sectors in China and ASEAN suggest that high-income ASEAN countries are increasingly specializing in R&D-intensive operations in the value chains vis-à-vis China, while China is doing so vis-à-vis low-income ASEAN countries. China's consolidation as a processing and assembly centre for high-income ASEAN parts and components, and the emergence of a similar partnership between low-income ASEAN countries and China, are an indication of more job opportunities being created for unskilled labour.

2.2. South Asia: The emerging value chains

2.2.1. China-India

The achievement of poverty reduction through revitalizing manufacturing and expanding exports is also the main theme of India's ongoing reform. India and China are comparable in many aspects. China's manufacturing and India's services are both important parts of the GVCs. However, India's IT-dominated services industry employs mainly skilled workers, and it cannot create enough job opportunities for its mass unskilled and mainly agricultural labour. Therefore, the poverty reduction effect of India's IT services is quite limited. The Modi administration has taken it on as the central task of its reform platform to revitalize India's manufacturing sector and to promote labour-intensive exports, which, if successfully implemented, would become a vivid replication of the "China miracle".

In the 1960s and 1970s, the Indira Gandhi administration formulated a series of economic policies to promote and ensure equality. Despite its original intention to protect workers and farmers on their own land, the Labour Law and the Land Act have today become obstacles to the development of a large-scale labour-intensive manufacturing sector (Panagariya, 2008). The *China-India Regional Trade Arrangement Joint Feasibility Study* was completed in 2007. However, India decided not to go ahead with formal negotiations due to concerns about competition from Chinese manufacturing.

In recent years, with the economic slowdown, the widening income disparity and the worsening of unemployment and poverty, public discontent was on rise in India, especially against the background of China's rapid development. Buoyed by strong national aspiration for economic growth, the Bharatiya Janata Party – which campaigned on a reform-for-growth platform – won more than two-thirds of the seats in the House of Commons in the 2014 election, which resulted in Modi being swept into power. Professors Jagdish Bhagwati and Arvind Panagariya, both advisors to the new Indian administration and leading pro-trade economists at Columbia University, have even developed a blueprint for India's reform. In their book *Why Growth Matters* (Bhagwati and Panagariya, 2013), which triggered debate on the country's future economic policy, they argue for further reform to liberalize labour and land markets.

This would provide firms with greater flexibility in hiring and firing workers, and reduce government interference with land transactions for the sake of labour-intensive manufacturing development. Although a strong defender of the multilateral trading system, in commenting on South Asian economic integration Panagariya believed that India should go for a free trade agreement with China, in order to introduce external competition in the manufacturing sector and spur domestic reforms. In place of the now defunct Planning Commission, in early 2015 the Modi administration installed the National Institution for Transforming India (NITI Aayog), chaired by the Prime Minister with Panagariya serving as his ministerial-level Vice Chairman, in charge of the overall development of India's reform strategy.

As part of India's manufacturing revitalization strategy, the Modi administration launched the "Make in India" initiative during late 2014 and early 2015. This initiative was aimed at encouraging domestic and multinational companies to engage in manufacturing production in India, thereby making it an important destination for foreign direct investment. This overlaps with China's interest in infrastructure investment in India and has also attracted investments from MIUI, Huawei, Lenovo and other Chinese high-tech companies. However, due to the shortage of skilled labour, development of India's high-tech manufacturing will face bottlenecks (Choudhury, 2016). However, for low-skilled processing and assembly or other low-end manufacturing industries in China, this will be a rare investment opportunity.

This appears to be an inevitable development, because it conforms to the reality of industrial labour shortage and manufacturing upgrading in China. The two countries have high demographic complementarity, as China has an ageing population and rising labour costs, whilst India has a young labour force. China's manufacturing upgrading and transfer abroad of its low-end labour-intensive industries (especially manufacturing processing and assembly) will certainly consider India a destination country, in addition to low-income countries in South-East Asia.

However, policies supporting the "Make in India" initiative are not yet in place. Two major questions remain unanswered: (a) will China's investments in India's low-end manufacturing industries be well received; and (b) will products made with Chinese investments be allowed to sell in India? Although they would provide a large number

of manufacturing jobs for low-skilled workers and help India to achieve its reform objectives, there is no policy guarantee such potential would be realized. The majority of India's manufacturing firms are small or medium-sized, and are mainly engaged in low-end production. Unable to realize economies of scale, they are very much concerned about opening up for Chinese trade and investments, given China's competitive advantages in the low-end manufacturing. This is precisely the reason why the *China-India Regional Trade Arrangement Joint Feasibility Study* in 2007 ended without any step being achieved, and why reservations exist in the "Make in India" initiative about receiving the transfer of China's low-end manufacturing. The solution to these problems requires not only legislative reforms in India to clear the path for manufacturing development, but also institutional innovations on the part of both countries in order to reduce political opposition to China's low-end manufacturing investment in India. With regard to China-India economic relations, particularly in response to the bilateral trade imbalance, better access to the Chinese market has become a policy focus among Indian researchers (e.g., Raju, 2015). This may obscure their vision for more productive cooperation in many other areas and for more effective domestic policy reforms aimed at boosting manufacturing.

2.2.2. *China-Pakistan*

China and Pakistan started free trade agreement (FTA) negotiations at the beginning of this century, and reached an agreement in 2006. Like India, Pakistan does not have an established supply chain relationship with China in manufacturing. However, the difference is that Pakistan is an all-weather ally of China, and depends heavily on China for economic, military and security reasons. As a country linking China's inland and the Indian Ocean, Pakistan is of great strategic importance for China. The China-Pakistan Free Trade Area not only serves to enhance their bilateral economic and trade relations; it also plays a key role in China's geopolitical strategy. It was China's original intention to fully consider the interests of Pakistan in the negotiations, which is also reflected in the final agreement. In terms of the number of tariff lines, China made more concessions.

However, in terms of utilization of the agreement, Pakistan actually made a greater number of concessions. For example, among all the agreed tariff reductions, Pakistan has only used 301 tariff lines, compared with 3,345 used by China. For sensitive

product tariff lines, Pakistan has used only 49 tariff lines, compared with 556 used by China. Pakistani concessions cover not only intermediates, but also final products that compete with local production. In addition, for Pakistan's products that have the greatest export potential, such as jewellery, textiles and plastic products, China's preferential tariffs for Pakistan are even higher than for ASEAN. The first-phase implementation of the agreement witnessed a huge influx of various Chinese products into Pakistan. Pakistani exports to China were instead quite limited, comprising mostly raw materials, agricultural and other primary products (Pakistan Business Council, 2013). In Pakistan, the FTA's negative impact has been felt across the manufacturing sector, and is reflected in a sharp decline of fiscal revenue and a growing trade deficit with China. The Pakistani public even ask whether Pakistan has really benefited from the FTA (Siddiqui, 2010; Maken, 2011).

The reasons for the undesired outcomes are twofold. Pakistan has thin trade policy capacity, while also lacking effective communications between trade negotiators and business community. Without the involvement of business representatives in the negotiation process, government negotiators may not have fully understood the real trade problems of the business sector. As such, even with genuine goodwill on China's part, it is hard to reach a trade agreement with full intended benefits for Pakistani firms.

It is undesirable for a trade agreement of great significance like this to generate unintended consequences simply because of a flood of China's manufacturing products into the Pakistani market, leading to political backlash and a blurring of its original strategic goals. The agreement was reached during the time when the Western countries were imposing sanctions on Myanmar's military Government, which is of equal geopolitical importance to China's alternative passage to the Indian Ocean. It was also during the time before the United States had conceived its "Asia Pivot" strategy. Today, when China's neighbouring countries are undertaking political reforms and a new regional and international order is shaping up, Pakistan's strategic importance is further highlighted. The experience of the China-Pakistan FTA suggests that trade policy capacity-building should be covered by Chinese foreign aid, including supply chain capacity-building. This is particularly important, as the China and Pakistan economic and trade relationship is getting ever closer.

2.2.3. China-Sri Lanka

Sri Lanka is a transportation hub in the Indian Ocean, and is located on major Chinese shipping routes. Like Pakistan, Sri Lanka's manufacturing sector is weak and has not been integrated into the GVCs. However, it maintains good relations with India and other major powers, and enjoys a multi-dimensional international space. In June 2014, China and Sri Lanka completed a joint FTA feasibility study, followed by the start of formal negotiations in September of that year (Chinese Ministry of Commerce, 2014). Amid this development, major changes in domestic politics in Sri Lanka have made it a pressing issue to establish bilateral industrial linkages through supply chains in order to avoid labour market shocks.

Sri Lanka is a democracy with elections of the president and members of the Parliament. During the 10-year tenure of former president Mahinda Rajapaksa, Sino-Sri Lanka economic and trade relations developed rapidly, with many large-scale investment projects being launched. However, Maithripala Sirisena of the opposition won the presidential election in January 2015, and further consolidated his power in the August parliamentary elections. The new Government has since changed its China policy and started to reassess China's investment projects. Obviously, in promoting bilateral economic and trade relations it is necessary to consider the new political climate in Sri Lanka, especially with regard to the economic interests of the ordinary voters.

Before the FTA negotiations started, renowned scholars in Sri Lanka were already prepared to help in defining the blueprint of the agreement. Saman Kelegama, Executive Director of the Institute of Policy Studies, argued that a future FTA must take care of Sri Lanka's two key concerns – more products entering China and the protection of their mature import substitution industries. Given the asymmetry of the two economies and the unbalanced bilateral trade relations, the Sino-Sri Lanka agreement should give Sri Lanka full special and differential treatment (SDT), following similar provisions in the India-Sri Lanka FTA. To relieve the import competition pressure from Chinese manufacturing, specific measures need to be adopted, including a longer negative list. The deep GVC integration of China's manufacturing sector places it in a position to help with Sri Lanka's GVCs participation through manufacturing integration of the two countries (Kelegama, 2014).

Although Kelegama's advice was given to Sri Lankan negotiators, it can also be borrowed to help formulate Chinese negotiating positions. The vast majority of Sri Lanka's exports to China are resources, raw materials and low-end manufactured products, with only a limited number of products under sensitive tariff lines. Therefore, it is not difficult for China to open its market to Sri Lanka to the maximum extent. As the local mature industries contribute to job creation and the formation of protection-seeking interest groups, forcing competing products into the Sri Lankan market will only incur strong political repercussions. Therefore, in the manufacturing market access negotiations, China should steer away from the local mature import substitution industries, and look towards industries that are not yet developed. For existing (mature or less-developed) industries, China should seek market access for parts and components, instead of final goods, with the aim of establishing bilateral industrial linkages. These should be the issues for consideration in the negotiations on market access, investment, services and other areas.

Countries in South Asia are under-developed in manufacturing, but they are becoming part of the GVCs. Meanwhile, Africa and the Pacific island countries are among the least developed, and have yet to be integrated into the GVCs; however, opportunities are available to them, mainly through Chinese investment and trade.

2.3 African and the Pacific island countries: Budding value chains

2.3.1. China-Africa

The African economy relies mainly on resource extraction and agriculture, while manufacturing is marginalized. According to the United Nations Conference on Trade and Development (UNCTAD, 2011), Africa's manufacturing sector accounted for 10.5 per cent of its total GDP in 2008, while for Asian developing countries it was 35 per cent. Africa's share in world manufacturing production and exports is even smaller, at only 1.1 per cent and 1.3 per cent respectively. For Africa's manufacturing GDP, the share of its labour-intensive manufacturing fell from 23 per cent in 2000 to 20 per cent in 2008. In addition, African manufacturing businesses are mostly small and informal. The sluggish development of labour-intensive manufacturing inhibits job creation, giving rise to a string of social ills such as poverty.

Since the inception of the Forum on China-Africa Cooperation in October 2000, China-Africa relations have entered a new stage, with the rapid development of economic and trade relations bolstered by China's investments in Africa. The total amount of Africa's exports to China surged twentyfold from 2001 to 2012, the bulk of which comprised mineral resources and products. China's investments in the resource sector, dominated by state-owned enterprises, are conducive to driving economic development in Africa. Yet, due to the low value-added of the mining industry and the fact that distribution of interests is primarily confined to the local governments and elites, this has failed to fully benefit people's livelihood. Coupled with the ignorance of environmental and ecological conservation, labour disputes and other issues, there has been a strong political backlash. The African Progress Panel, led by Kofi Annan, former Secretary-General of the United Nations, recently released a report that lashed out at foreign enterprises which were wreaking havoc in Africa. The report also made some prudent criticisms of China's practices in Africa for their lack of transparency and being devoid of social responsibility (Africa Progress Panel, 2013). Against this backdrop, development of labour-intensive manufacturing in Africa in order to create jobs for the local population serves not only the needs of China in restructuring its economy through outbound industrial transfer, but also meets the requirements for further development of China-Africa relations. In this regard, GVC cooperation is a good entry point (Davies *et al*, 2014).

Africa's market capacity is limited. The often-mentioned advantages of investing in Africa's manufacturing industries include the convenient duty-free and quota-free access to China and other international markets. However, the bottleneck of Africa's exports is supply constraint, i.e., a lack of infrastructure and the capacity to accommodate the whole set of manufacturing projects. Massive infrastructure investments take a long time to yield profits; however, a rise in production capacity of African manufacturing is not a sure thing due to a dearth of human resources and other facilities.

Undoubtedly, Africa needs foreign aid. However, weak governance capacity and political instability are root causes of the chronic poverty in Africa (Mills, 2010). These constraints mean that export-oriented manufacturing of an appropriate size is the

choice that fits well with the local conditions. This, in turn, defines Africa's limited manufacturing GVC integration. Nonetheless, cases of Africa's successful GVCs participation can serve as positive examples. The Huajian Shoe Factory, located in Ethiopia's Oriental Industrial Park, combines Chinese design, technical equipment and marketing expertise with rich raw leather and cheap labour in Africa. It has made the country's footwear industry a part of the GVCs. While confined to the industrial park, and without creating a greater number of low-skilled jobs, the Huajian story involves positive infrastructure development, trade and investment policy innovation and many other practices required to build a value chain. As such, it showcases the promising prospects of China's possible Africa policy adjustments.

2.2.4. China-Pacific Island Countries: Services

If inadequate infrastructure and political instability are the reasons behind the bleak near-future prospects of large-scale GVC participation by Africa's labour-intensive manufacturing industries, geographic remoteness creates the same fate for the Pacific island countries (PICs). More importantly, their geographic locations cannot be changed. For PICs, the economic and social development strategy of GVC participation by labour-intensive and low-end manufacturing is not a viable option, and hence an alternative route defined by their own comparative advantage needs to be explored in the services sector.

Although the PICs have a small population and tiny land areas, they cover zones in the vast South Pacific Ocean which boasts rich marine and mineral resources. From the marine strategy perspective, they occupy important geographic locations. In 2006, the "China-PICs Economic Development and Cooperation Forum" was launched and the bilateral relations have since developed rapidly. The 2006 military coup in Fiji, the largest Pacific island country, prompted the West to impose sanctions on the military regime. This was another factor that helped strengthen China-Fiji relations, which in turn helped leverage the development of China's relations with other PICs. This has resulted in soaring investment and trade volumes between China and PICs. China exports a variety of manufacturing products to PICs, while importing minerals, forests and seafood. In PICs, China has become an important infrastructure investor in roads, ports, schools and other areas. As pristine tourist attractions, the PICs are a net exporter of services (Yao *et al*, 2013).

The PICs are low-income countries. The Western sanctions on Fiji affected the whole region. Moreover, the PICs manufacturing sector lacks growth potential because it is subject to the constraints of small domestic markets and difficult access to international markets due to their geographical remoteness. Thus, there is limited possibility of achieving social and economic development by promoting manufacturing. In the meantime, their fragile ecological environment restricts the development of resource-related industries. On the other hand, however, as former British colonies, countries of the region belong to the Commonwealth and are rich in English-speaking human resources. Being in a unique time zone, they could become English-language call centres to serve Chinese businesses.

Compared to India, except for the difference in size, what is special about the PICs English services industry? First, India's comparative advantage in services is not real. It shows up only as a result of labour market distortion and manufacturing depression. The Modi administration's "Make in India" initiative, if successful, will improve the infrastructure, unify the labour market, and thus fully reveal the real comparatively advantaged industries of the Indian economy, i.e., labour-intensive manufacturing. When that happens, skilled workers will leave the services sector for manufacturing jobs, resulting in services shrinkage. For PICs, however, the prospect of a swap of revealed comparative advantage between manufacturing and services does not exist and their comparative advantage in services will remain in the long term. Second, India's services industry is part of the IT value chains of the English-speaking world (mainly the United States), plus low labour costs (not English itself) form the source of its comparative advantage in services. For Chinese manufacturing, PICs call centres would mainly provide specialized English services, making them more complementary. Third, in order to effectively tailor services projects, the client countries need to maintain close economic and trade contacts and cultural exchanges with the providing countries. In recent years, China has become one of the region's most significant non-English speaking partners in trade and investment. The establishment of the Confucius Institute could serve as a platform for language project cooperation.

Chinese export-oriented firms are gradually establishing marketing and other high value-added businesses. Their transformation and "going global" demands high-

quality English services. In China's economic and trade cooperation with the region, it should become a key task to help tap the local comparative advantage in English language services, derived from their unique geographic location and historic background, in order to forge supply chains with Chinese manufacturing.

After Fiji's democratic election in September, 2014, the Western countries wasted no time in lifting the sanctions and returning to the region. President Xi Jinping's visit to the South Pacific in November 2014 again placed the region in the spotlight. To protect China's economic and strategic interests in the region's future political development, there is a pressing need to optimize the country's investment and development projects in order to benefit the people as much as possible.

3. China's processing trade regime: Lessons for BRI countries

China's processing trade regime can be applied to building value chains in the BRI, as it is required by the local conditions and it also provides the necessary policy support for transferring Chinese industries overseas. In general, the developing and the least-developed regions have large poor populations, especially in the rural areas, and they are in pressing need for inclusive trade growth. At the same time, to protect domestic industries and fiscal revenue, trade protection is usually more stringent. These countries tend to be on the defensive in Doha non-agricultural market access (NAMA) negotiations and are particularly concerned about China's labour-intensive manufacturing that competes directly with local firms.

This is very similar to the Chinese situation. China's early industrialization emphasized capital-intensive heavy industries. In the reform era, policy support for technology-intensive strategic industries has remained in place, and China has always tried to strike a balance between opening up trade and protecting its import-competing industries. During the early years of China's opening up, its participation in international division of labour was mainly through the "foreign parts, domestic assembly and home sales" model, which was the most basic form of value chain integration. Technically, it was not the real "value chain trade" because no domestic value-added was exported. Since the early 1990s, facilitated by the processing trade

regime, value chain integration has been deepened through the "foreign parts, domestic assembly and export" model.

Export processing is not unique to China. However, Chinese innovation is going beyond the usually confined processing trade zones, to carry out large-scale export processing operations throughout the country. The key to its success lies in its innovative customs management, i.e., no tariffs and value-added tax exemption for imports, and no domestic sales allowed to ensure the imports are exported. This processing trade regime facilitates large-scale cross-border flows of parts and components, protects domestic industries from external shocks and avoids the loss of tariff revenue. It also helps create a huge number of processing and assembly jobs.

In comparison, processing trade practices are still at the preliminary stage in the BRI countries. Some of them sell the final products domestically (thus not really participating in GVC production), such as the case of electronics and machinery in low-income ASEAN countries and India. Some confine export processing activities to designated industrial parks, such as the Huajian Shoes Company in Ethiopia's Oriental Industrial Park. Selling domestically faces the market limitation problem, whilst setting up small enclosed areas as processing trade zones to export assembled products is a good idea only for policy experiment. To achieve large-scale poverty reduction and inclusive trade growth, however, processing and assembly job opportunities need to be extended to the wider low-income population. Also, policy measures need to be in place to extend the processing trade operations to much larger geographic areas.

Foreign academics and policy researchers are very interested in China's manufacturing export experience. However, their focus is often on Special Economic Zones (SEZs) (Aggarwal, 2012). The processing trade regime is a customs management system that goes well beyond SEZs. It comprises the coordinated supervision of foreign trade involving various agencies with jurisdiction over commerce, customs, quality inspection and quarantine, taxation and foreign exchanges, which is fundamentally different from SEZ management. To successfully move China's manufacturing abroad, especially the processing and assembly industry, requires not only investment in industrial parks and other infrastructure, but also the establishment of a customs management system similar to China's export processing regime.

In India, it is right time for China to make hardware infrastructure investments, to introduce its processing trade and other policy software, to re-visit the idea of a Sino-Indian FTA; and to speed up bilateral manufacturing linkages with GVC integration as a focal point. In Africa, a more realistic approach would be to experiment with export processing management in enclosed industrial parks. While this cannot create a large number of jobs for low-skilled workers, it can serve as a good demonstration for future policy development. At the current stage of the BRI, it is not only the needs of the BRI countries but also the needs of the go-global and domestic optimization strategy of China's processing trade industry that China provides aid for trade governance capacity building, helps install processing trade regime and supports physical infrastructure investment with matching policy software (Chinese State Council, 2016).

While Africa's export supply constraints make it unable to take full advantage of the preferential terms in accessing major international markets – i.e., duty-free and quota-free treatment for most products – the fact that ASEAN and some South Asian developing countries have growing market access opportunities in developed countries makes them good overseas destinations for China to transfer its processing trade firms. A good example is the evolution of the United States' Generalized System of Preferences (GSP), which is designed to give developing countries, including many BRI countries, preferential market access– i.e., tariffs lower than the most-favoured nation rates, usually zero tariff, for their products. Moreover, product and country coverage is also expanding.

At the end of June 2016, the Government of the United States announced it would expand the zero-tariff treatment to all travel goods, which normally attract 4 per cent ~ 20 per cent most-favoured nation tariff rates. The zero tariff for travel goods applies to 38 African countries covered by the African Growth and Opportunity Act and 43 other "least developed" and "GSP" countries. The share of African zero-tariff beneficiaries in the United States market is negligible, and the export supply constraints render zero-tariff treatment virtually ineffective in advancing poverty reduction and development in Africa. China, on the other hand, is a major exporter of travel goods; for example, China and Viet Nam make up 90 per cent of the United States market for travel goods, amounting to US\$5 billion. Chinese products are very competitive and

zero-tariff treatment for African countries does not pose a threat to its presence in the United States market. Due to their unfavourable investment and production environments, such market access incentives are not strong enough for firms to move from Asia to Africa. In June 2017, the Government of the United States extended the zero-tariff coverage of for travel goods to all GSP countries.

This policy move has important implications. If fully implemented, not only the two least developed ASEAN countries, Cambodia and Myanmar, but also Thailand, Indonesia, the Philippines, India, Sri Lanka, Pakistan and other BRI countries will enjoy zero tariffs for their travel goods. These countries have very promising export prospects. For example, the Philippines' travel goods industry is expected to grow by US\$100 million annually and the Government plans to increase investment in the industry during the next five years to create 75,000 jobs (Rushford, 2016). This is undoubtedly an important opportunity for China's processing trade industry to increase their overseas presence. In this context, establishing a processing trade regime in these countries can promote the formation of the sector's value chains, which would help bring the BRI countries closer through joint efforts to improve people's livelihood.

4. Building China-BRI value chains through "Aid for Trade"

Chinese aid to the BRI countries is mostly for infrastructure. Although this aid strategy may ultimately promote trade in these countries and benefit the poor, assistance focusing on aid programmes specifically designed to overcome trade bottlenecks and bring low-income people into the global trading system will be more effective and sustainable in terms of poverty reduction. This was also the vision of the "Aid for Trade (AfT)" initiative. which covers two main areas: infrastructure and human resources investment, and trade policy capacity-building. Although these elements are already present in China's current foreign aid projects, it is of special significance to organize Chinese foreign aid in the BRI under the AfT framework.

First, the AfT operational mechanisms include a systematic diagnosis of trade and development needs for a country as well as subsequent aid prescriptions. Since the

AfT and BRI share the same vision, the former can serve as an organizational framework for the latter to coordinate and integrate aid projects, create synergy among projects and, ultimately, improve their overall quality and efficiency. This will help solve the problem of Chinese projects being loose, disorderly and fragmented in organization and implementation, thus making Chinese foreign aid more sustainable.

Second, empirical evidence suggests that AfT is particularly helpful for developing and the least developed countries in their GVC participation. It is estimated that each AfT dollar will increase export by US\$8 for developing countries and by US\$20 for the least developed countries. In addition, when compared with overall exports, AfT is more effective in boosting export of intermediate goods such as parts and components (OECD and WTO, 2013; table 5.1, p.155; and figure 5.2, p.158). Using the gravity model, Vijil (2014) studies the effectiveness of AfT in different areas and finds that AfT and regional trade arrangements are complementary. Aid in institutional capacity-building (e.g., trade policy capacity-building) shows the best result compared with that for infrastructure and production capacity-building. Each additional aid dollar leads to US\$27 more exports by a recipient country to other member countries of the regional trade agreements. These studies provide empirical references for Chinese AfT projects in BRI countries, especially for aid in processing trade and GVCs management capacity-building.

Finally, as part of China's foreign aid, AfT can serve as a bridge between China and Western countries in foreign aid cooperation. China's development assistance is growth-driven, with a focus on practical results, while OECD countries' development assistance is process-driven, with a focus on Western democratic processes, such as good governance, accountability, transparency and participation. The two operate under different frameworks (Wang and Liu, 2012). This difference makes the China model susceptible to Western criticism. The Chinese Government is well-aware of the need to make appropriate adjustments in matters of non-principle to reduce political friction. It has become a consensus in the Chinese policy community to upgrade the Chinese aid programme by providing more aid through multilateral agencies in parallel with bilateral aid efforts. Assistance to BRI countries under the WTO AfT framework is in line with the development of China's foreign aid policy (China WTO Society, 2014).

To build the BRI value chains through processing trade regime requires the support of a package of policies and infrastructure projects. Each BRI country has its own unique conditions that require a tailor-made aid package. With the success of its processing trade regime, and as a major donor in South-South cooperation, there is much China can do through the AfT initiative.

5. Conclusion

The interplay of globalization, national sovereignty and democratic politics has made it difficult for national governments to coordinate trade and social policies. To deal with this trilemma, Rodrik (2011) argues for allowing more policy space by reforming WTO rules. In fact, this can be achieved within the existing WTO framework, just as China has done with its processing trade regime. Today, the pattern of “flying geese” in manufacturing is emerging across the BRI region, which is also confronted with the trilemma as described above. In light of this development, China’s successful experience in processing trade and GVC management can be shared by BRI countries.

Policymakers in China need to be fully aware of the possible disruptive effects of democratic politics in BRI countries on the region’s economic integration. It would be better to align China’s resource and infrastructure-heavy development cooperation with building local manufacturing capacity. To promote inclusive manufacturing export, the AfT programme can form an organizational framework for various aid projects, including the management of GVCs, under a processing trade regime.

The understanding in the BRI countries of China’s manufacturing success should go beyond the SEZ policy, which has been highly publicized as part of “China’s Miracle” and prominently featured in various trade policy training programmes. Undoubtedly, massive creation of GVC manufacturing jobs is a result of China’s open-door policy symbolized by SEZs. At the technical level, however, it is made possible by a special customs management system. Keeping this in mind, the BRI countries will be better prepared to engage China or international agencies in designing trade policy capacity-building, and other research and aid projects.

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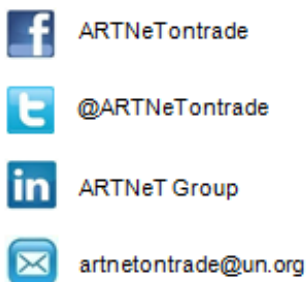
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