



Future Direction of International Trade Systems: Institutions matter – a rise of “peer value chains”

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Key points

- Institutional similarity will be even more important in shaping global value chains than geographical proximity
- Multinational firms will seek to offshore production to countries with robust institutions akin to their home business environment
- Complete decoupling of the world economy is inconceivable, but partial decoupling is probable

According to Richard E. Baldwin, Professor of the Graduate Institute of International and Development Studies, the international production system is based on tri-polar networks of Factory Asia, Factory North America and Factory Europe. Namely, global value chains (GVC) are not truly global, but are more likely to be regional.

How will GVC look like in the post-COVID19 world? They are considered to evolve from regional value chains based on geographical proximity to production networks connected through institutional similarity (of legal systems or technological profiles, for example).

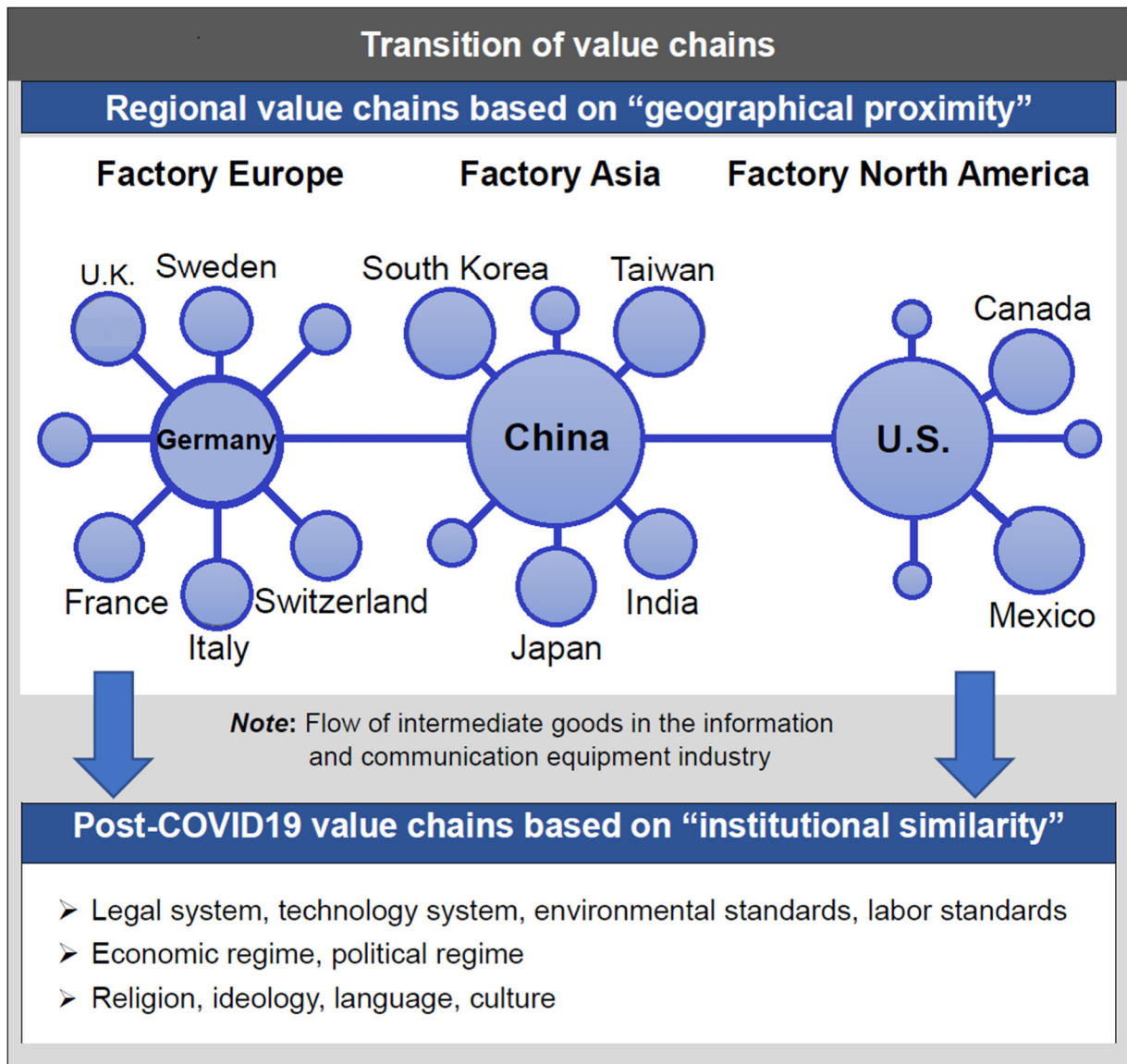
In the traditional theory of international trade, flows of goods and services are determined by the respective countries' comparative advantages. Endowment of production factors, such as labor, capital (including human capital) and land (natural resources), determines their comparative advantages. In the era of the Fourth Industrial Revolution, however, the relative importance of labor factors has declined significantly as a result of the introduction of autonomous robotics, smart sensors, and artificial intelligence into production lines.

Meanwhile, institutional factors became a main source of country's comparative advantages. Nathan Nunn, Professor of Economics, Harvard University, asserts that products produced through complicated supply chains involving various transactions may be called “contract-intensive.” Analogous to the classical statement that a country with ample labor force has a



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comparative advantage in labor-intensive industries, the quality of a country’s legal system affects its international competitiveness in the production of contract-intensive products. In his study, Nunn demonstrates that firms in a country with an advanced legal system perform better in the production of products involving complicated transactions and tends to export these products.



Likewise, a country with an appropriate legal protection of intellectual property rights has comparative advantages in knowledge-intensive industries. A variety of rules that support fair and transparent economic activities such as the rules on competition, government procurement and licensing are important sources of advantages, too.

Also, whether a country can participate in technology-intensive GVC depends much on the availability of relevant physical infrastructure (capital factor) and operational skill in handling the production facilities (human capital factor) as well as whether the country’s technological standards (institutional factor) are compatible with global technology ecosystems.

Further to this, lead firms nowadays are paying closer attention to the issues like environmental protection and labor standards of sourcing countries in formulating global strategies, in response to the growing public interest in corporate social responsibility for sustainable development. The presence of qualified domestic standards for these issues can be important determinants of competitiveness for supplier countries.

What makes institutions ever more important in shaping GVC? Alongside the recent increase in geopolitical tensions, political/diplomatic motives are looming over core economic arenas, and firms became anxious about arbitrary state intervention such as asset freeze and forced technology transfer.

On top of this, the pandemic occurred. Civil fears and anxieties against social unrests are mounting, and it is envisaged that the governments of many countries may respond to, or even capitalize on, such public mentality by means of strengthening their controls over social and economic activities. Facing such risks and uncertainties in global businesses, multinational firms will look for the countries endowed with robust and rule-bound domestic institutions, especially those akin to business environments of their home countries.

Surely, GVC is expected to keep up its momentum for geographical expansion, thanks to the rapid advancement of logistics services and information and communication technologies (ICT). Further to this, COVID-19 outbreak raised firms' risk awareness associated with the concentration of production capacities in a specific country or region. Diversification of procurement sources is a pressing issue for companies, leading to further geographical expansion of GVC.

However, the main driver of GVC expansion may no longer be wage differentials between countries. Instead, the international production system may be headed toward production sharing among countries with common institutional frameworks; namely, from regional value chains to "peer value chains."

This view has some important implications for international relations. If GVC develops along countries' institutional similarities, it may raise the possibility of economic decoupling between countries with different institutional frameworks, for example, between the United States and China, and between their economic allies.

Further to this, GVC may face an additional risk of so-called "digital divide" if the level of technological achievement and standardization are taken into account. We then envisage a Cold War-like scenario, in which the development of supply chains is bifurcated among competing regimes while each of them strives for captivating less technologically developed countries into its allies.

This said, decoupling is unlikely to occur at the level extending to the entire range of economic activities in such an interdependent and intertwined world economy of today. It is instead considered that cross-border production sharing will be just partially decoupled in a highly managed manner, implemented in only limited fields that relate to national security and sovereignty, such as foods, water, energy and medical supplies as well as ICT services.

Nonetheless, it is extremely difficult to re-integrate supply chains once they have paved different evolutionary paths. In particular, the world economy will suffer a significant loss if the

emerging 5G arena in the ICT industry is doomed to be fragmented. Also, the supply management of energy, foods and medical products have direct impacts on the global issues like environmental protection and poverty alleviation, the areas which require a broad and deep international cooperation toward the achievement of the Sustainable Development Goals (SDGs). Furthermore, declining opportunities for cross-border communication and knowledge sharing will curb the advances in science, technology and culture, and may discourage peaceful dialogues and trust-building efforts among countries.

Decoupling risks are most likely to rise in Factory Asia since it is a melting pot of heterogenous economic regimes. Japan, as a leading advanced economy of the region, should play a principal role in managing these risks, perhaps through the leverage of regional cooperative frameworks such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP11) and the Regional Comprehensive Economic Partnership (RCEP).

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