Chapter 11

The Globalization of Production

Chapter by Eric Thun

John Ravenhill

Global Political Economy, 3rd edition

OXFORD Higher Education

Lecture Plan

- Introduction
- The Rise of Global Production
- Global Value Chains
  - Governance
  - Location
- Conclusion

Introduction (1)

- In 2008,
  - There were some 82,000 parent companies with over 810,000 affiliates
    - They employed approx. 77 million people
    - They accounted for one-third of total world exports of goods and services
- Forms of globalization of production
  - MNCs own assets and employ people through FDI
  - Firms who control global value chains
    - These firms use contractors who work to specifications

Introduction (2)

- Two sides to global production
  - From the perspective of “home” countries
    - What is left behind when production moves abroad?
    - There is a ear of a “hollowing out” effect
  - From the perspective of “host” countries
    - Can “host” countries capture high value-added activities?
    - Or be trapped into a dependent relationship with MNCs?
    - What is the effect of foreign firms on local social, political and environmental standards?
- Global value chains can determine who gets what, when, and how in the global economy

Rise of Global Production (1)

- The history of foreign investment or international production can be traced back to 16th century chartered trading companies
- Through FDIs, firms attempted to
  - Internalize and seek greater control of the process of production
  - Gain access to markets
- Today, the novelty lies in the <u>magnitude</u> and the <u>degree of fragmentation</u> of contemporary global value chains

Rise of Global Production (2)

- Value of FDI inflows increased from
  - $59 billion in 1982 to
  - $1,697 billion in 2008
- Ratio of world FDI inflows to global gross domestic capital formation increased from
  - 2% in 1980 to 12.3% in 2008
- Two key trend of these flows
  - High concentration in developed economies
  - M&As between existing firms, rather than greenfield (new) investment, dominate

Rise of Global Production (3)

- Developing countries seeking external capital investment have four choices
  - Official flows
  - Commercial bank loans
  - Portfolio flows
  - FDI
- Until early-1990s, official flows were dominant source of capital for developing countries
- In 1990s, there was a dramatic shift towards private capital flow

Rise of Global Production (4)

- FDI flows to developing countries are concentrated in Brazil, China, Hong Kong, Mexico and Singapore
- FDI is the most stable form of foreign capital
- FDI can bring with it a package of benefits to the host economy: technology, managerial skills, access to new markets

Rise of Global Production (5)

- The outsourcing of production is another form of the globalization of production
- It is very difficult to determine the value of outsourcing transactions
  - A variety of proxy measures can be used to suggest the extent of this increasingly significant activity

Rise of Global Production (6)

- Explaining the expansion of global production
  - The global liberalization of trade
    - The fragmentation of value chains requires low tariff barriers
  - The growth of market-based policies
    - This expanded the range of options for global production
  - New technology
    - New forms of transportation & telecommunication, standardized shipping containers, shift to modularity
    - This helped to expand the geographical reach of business and made new forms of business organization possible

Global Value Chains: Governance (1)

- With the fragmentation of value chains, how are the various parts coordinated?
  - Two ends of the spectrum
    - At one end, pure market relations with foreign firms
      - In the ideal world of the neoclassical economist, firms would not invest abroad but resort to arm's-length trade relationships
    - At the other, hierarchical control of foreign operations
      - Hierarchical coordination might be more appropriate than market coordination when there are transaction costs, bounded rationality, opportunism, advantages of internalization, firm-specific advantages, location-specific advantages

Global Value Chains: Governance (2)

- The global commodity chain framework (Gereffi and Korzeniewicz 1994)
  - Used to differentiate between different forms of global value chains
  - There are different "nodes" in a value chain
    - "Nodes" are pivotal points in the production process (supply of raw materials, production, export, marketing)
  - Control of various nodes is translated to power and profit
  - Two types of commodity chains were identified
    - The buyer-driven chain and the producer-driven chain

Global Value Chains: Governance (3)

- What determines the organization of a global value chain? (Gereffi et al. 2005)
  - The complexity of inter-firm transactions
  - The degree to which this complexity can be codified
  - The extent to which suppliers have the necessary capabilities to meet the requirements of the buyers
- Different combinations of these factors result in different forms of governance

Global Value Chains: Governance (4)

- Five forms of governance were identified
  - Market relations
  - Modular value chains
  - Relational value chains
  - Captive value chains
  - Hierarchical coordination

Global Value Chains: Governance (5)

- The form of governance is important as it determines who reaps the gains in terms of
  - The distribution of profits among firms
    - Important factors: switching costs and barriers to entry
  - The capabilities that firms within the chain are able to master, and thus upgrade their prospects
  - The leverage points for policy initiatives

Global Value Chains: Location (1)

- Why do value chains become global?
  - Some argue that it is an evolutionary process of product cycles and economic development
    - This argument was appropriate when forces of technology and product innovation were highly concentrated & rate of change was slow and predictable
    - In the contemporary global economy
      - Product life cycles are now a lot shorter with rapid technical change and product proliferation
      - Moving production offshore only happens with a part of, rather than the entire, production system resulting in only partial diffusion of technology
      - The low cost of labour is not the only reason for offshoring

Global Value Chains: Location (2)

- Why do value chains become global? (cont.)
  - Location-specific advantages: a firm will invest abroad in order to access the immobile resources of a particular place
    - But how do different locations develop particular capabilities or advantages?
    - The “varieties of capitalism” approach argues that the advantages of a particular location are not endowed by nature but are the result of a complex constellation of interrelated institutions
    - Location-specific advantages do not necessarily reside at the national level but can also be found at sub-national levels

Conclusion

- For developing countries, the rise of global production creates new opportunities but also real risks
  - Not all countries are able to attract FDI
  - Those that are able to attract FDI may not be able to maximize the benefits for local firms
- For developed countries, the gains from globalization are not evenly distributed
  - There is a risk that this imbalance will create the possibility of a backlash against globalization