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Promoting the Export Competitiveness of SMEs

Issues note by the UNCTAD secretariat*

Executive summary

The Commission on Enterprise, Business Facilitation and Development, at its eighth session in Geneva (12–15 January 2004), discussed the issues note "Policy options for strengthening SME competitiveness" (TD/B/COM.3/58), which recommends concrete policy options that developing countries could adopt to strengthen enterprise competitiveness. The Commission decided to continue its work in this area with a focus on enhancing the export competitiveness of small and medium-size enterprises, including through possible link-ups to international supply chains.

A leading concern of developing countries with respect to their participation in global trade is their lack of ability to compete internationally. They need to solve supply-side constraints, build national productive capacity and develop an efficient trading and transport infrastructure. The São Paulo Consensus states that "building productive capacities and enhancing international competitiveness requires a collective and coherent effort, primarily by the developing countries concerned, but also by home countries, investors and the international community as a whole". Various stakeholders are involved to different degrees in enhancing developing-country SMEs' export competitiveness.

This paper examines policies and actions that could be taken by governments, the private sector and the international community to help improve the export competitiveness of SMEs in developing countries. Linkages with transnational corporations deserve special attention, as these private actors are increasingly playing a leading role in world production, trade and finance. After briefly discussing the concept of export competitiveness, Part I outlines the changing international context, which results in new opportunities and risks for SMEs. Part II summarizes possible ways for SMEs to gain access to international markets and then discusses the rationality of SME export promotion through foreign direct investment and business linkages. Part III suggests policy recommendations for the various private and public stakeholders responsible for enabling SMEs to export successfully.

* This document was submitted on the above date owing to technical delays.

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INTRODUCTION

1. Trade and investment have long been considered powerful instruments to promote development. They open new markets and permit the expansion of productive capacity and higher levels of income and employment. One of the main concerns of developing countries with respect to their participation in global trade is their lack of competitiveness. They need to solve supply-side constraints, to build up national productive capacity as well as an efficient trading and transport infrastructure, and to engage fully in a coherent export and investment promotion strategy. To be a real tool for development, global trade must locally induce a virtuous circle involving diversified higher-added-value exports and better-paid jobs. Mere increases in exports do not guarantee development. According to the *World Investment Report 2002*, "greater competitiveness allows developing countries to diversify away from dependence on a few primary-commodity exports and move up the skills and technology ladder, which is essential to sustain rising wages. It also permits the realization of greater economies of scale and scope by offering larger and more diverse markets" (UNCTAD 2002a). This means diversifying the export basket, sustaining higher rates of export growth over time, upgrading the technological and skill content of export activity, and expanding the base of domestic firms able to compete globally.

2. The export competitiveness of a country depends on its domestic enterprises, including SMEs. The export competitiveness of a firm depends on its ability to sustain or expand its position in international markets – directly or indirectly – by supplying quality products on time and at competitive prices. This requires flexibility to respond quickly to changes in demand and skills to successfully manage product differentiation by building up innovative capacity and effective marketing channels (UNCTAD 2002b).

3. SMEs represent the bulk of production in manufacturing and an even larger share in services, both in developed and developing countries. They contribute over 55% of GDP and over 65% of total employment in high-income countries (OECD 2004a). In developing countries, SMEs are responsible for most employment and income generation opportunities and can be identified as a main driver for poverty alleviation. The flexibility and specialization of SMEs can also contribute, in some cases, to the adaptability and diversification of national production systems.

4. In international trade, the contribution of SMEs to direct export revenues is less obvious and varies greatly, even among OECD economies. For example, SMEs contribute a substantial share of East Asian manufactured exports (56% in Taiwan Province of China, over 40% in China and the Republic of Korea, more than 31% in India), whereas their role is marginal in LDCs, especially in Africa, with the little-documented transborder and subregional trade. The central question is whether a higher proportion of competitive SMEs in developing economies could access regional and global chains of production.

5. The export capacity of local SMEs can be enhanced, among other ways, through appropriate trade and investment linkages, upstream and downstream the production and service activities of TNCs and other large firms. Such business linkages already play an increasingly significant role in various segments of local SMEs, which can thus move up the technological and management ladder and become part of global and integrated chains of production.

6. Over the past four years, the Commission on Enterprise, Business Facilitation and Development has analysed various policy options for growing and strengthening SMEs in developing

countries. A number of issues notes have been prepared by the UNCTAD secretariat on the theme of enhancing the productive capacity and improving the competitiveness of SMEs.[1] Considerable work has also been done on the subject of the competitiveness of SMEs at the international level, in particular on linkages between SMEs in developing countries and foreign affiliates of TNCs.[2] This paper relies on these precedent works but goes further in analysing the new context of global competitiveness and focusing on policy options at the national and international levels to promote the export competitiveness of SMEs, including through linkages with TNCs.

I. SME EXPORT COMPETITIVENESS: A NEW CONTEXT OF GLOBAL COMPETITION

A. A brief discussion of the concept of export competitiveness

7. Since an enterprise does not produce in a vacuum, its competitiveness can only be measured within various types of market territories at the subnational, national and supra-national levels. The optimization of its capital resources (finance, technology, labour) commands its ability to penetrate each of these three market territories. Metcalf, Ramlogan and Uyarra (2003) maintain that competitiveness is embodied in the characteristics of the firm, namely through:

- the current efficiency and effectiveness of the use of resources;
- the willingness and the ability to relate profitability to growth of capacity through continued investment; and
- the ability to innovate in technology and organization and thus improve efficiency and effectiveness of production.

8. Competitive advantages, which must be measured in relation to rivals in markets, are determined by how efficient and effective the prevailing markets for products, labour and capital are. Entrepreneurship capacity refers to the introduction of new productive combinations and innovations acting as driving forces, which continually create new competitive advantages and opportunities for profit and growth.

9. Meyer-Stamer (1995) concurs with the view that competitiveness is created at the firm level, but that it is partly derived from a systemic context, emerging from complex patterns of interactions between government, enterprises and other actors, and will therefore exhibit different forms in each society. SME development strategies will thus necessarily be country- and context-specific. Each country will have its own challenges, opportunities and priorities for change, and resources available for implementation will vary by country.

10. A firm benefits from externalities derived from the existence of technological capability and export competitiveness at the national level. Lall (2000, p. 21) stresses that "national technological capability is more than a sum of capabilities of individual firms in a country. It is an innovation system, which includes the externalities and synergy generated by the learning process, ways of doing business, and the knowledge and skills residing in related institutions".

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[1] UNCTAD 2001a, 2002b, 2002c, 2003a, 2003b.

[2] A document (UNCTAD 2000a) was published and discussed during a special round table on "TNC–SME Linkages for Development" held during UNCTAD X in Bangkok in February 2000; the *World Investment Report 2001* (UNCTAD 2001b) focused in its second part on linkages between foreign affiliates and domestic firms; and an Expert Meeting on the Relationship between SMEs and TNCs to Ensure the Competitiveness of SMEs was held in November 2000.

11. External competitiveness can be achieved by firms through exports, sustaining diversification and/or better quality of production, upgrading technology and skills, and expanding the base of domestic firms to compete regionally and globally. A firm is competitive in external markets depending on its ability to supply quality products on time and at competitive prices and to respond quickly to changes in demand by building up innovative capacities and market strategies.

12. Few empirical studies have debated the correlation between SMEs' domestic and export competitiveness. A central issue of this debate is whether SMEs should become competitive on the national market first, before considering (spontaneously or otherwise) to internationalize through exports.

B. New opportunities and risks for SMEs' access to global markets

13. The twin processes of globalization and liberalization, combined with rapid advances in information and communication technologies, have opened up a new era in terms of government policies, enterprise organization and multilateral disciplines. Public policies based on local development, state intervention and import substitution appear to be losing out to a more liberal approach in most developing countries. At the same time, a new global production system has emerged in which enterprises, especially TNCs, tend to specialize more narrowly in their core business and to contract out functions to other firms, spreading them internationally to take advantage of differences in costs and logistics. At the multilateral level, many developing-country governments have signed commitments that restrict them to a multilateral discipline and limit the autonomy of their national economic policy in favour of their enterprises.

14. The combination of trade globalization and liberalization may allow greater economies of scale and scope for a small segment of already competitive SMEs, at the very least vis-à-vis one of the driving global markets (the United States, the European Union or Japan/Northeast Asia). Globalization can provide them with better access to standardized market information and to larger and more diverse markets. It may also facilitate a new physical or virtual proximity between global buyers and local SMEs having an established niche or demonstrating innovation and business success capacity in domestic and subregional/regional markets. This is increasingly true also in the service sector, as the case of the software industry in India demonstrates. According to the *World Investment Report 2004,* the production of entire service products is currently distributed internationally in two ways: through the establishment of foreign affiliates ("captive offshoring") or by outsourcing to a third-party service provider ("offshore outsourcing"), based on the comparative advantages of individual locations and the competitiveness-enhancing strategies of firms (UNCTAD 2004a).

15. On the other hand, global competition may also challenge the vast majority of purely domestic SMEs, whose products and sales are, most of the time, extremely localized and segmented. Trade liberalization increases the ability of well-established foreign manufacturers and retailers to penetrate remote and underdeveloped markets and makes it increasingly difficult for SMEs to survive or maintain their business position in the local and, if applicable, the global market. Moreover, the rapid decline of trade barriers and the internationalization strategies of TNCs are making it more difficult for domestic firms, especially SMEs, to qualify as regular suppliers and be included as units of global systems of production. In addition, global market governance tends to advocate, also through multilateral trade and financial institutions, macro-policies that largely ignore the micro-economic conditions needed for a smooth enabling environment for SMEs.

II. SME EXPORTING ACTIVITIES: THE STRATEGIC ROLE OF TNC-SME LINKAGES

A. Traditional patterns of SME internationalization through exports

16. Exporting has been the traditional way for SMEs to internationalize. However, other ways are gaining importance. The internationalization of SMEs can be now realized through a number of cross-border activities, including international investment and participation in strategic alliances, partnerships and networking arrangements, affecting a variety of business functions ranging from research and product development to distribution (OECD 2004b). This paper will focus on export activities, nevertheless keeping in mind that these different forms of internationalization may interact with and reinforce each other. There are different ways or strategies for SMEs to access external markets through exports:

- Some independent[3] and highly skilled SMEs have proven their strong export capacity through specific niche and highly profiled productions. Foreign buyers are particularly attracted by such local producers. This concerns a very limited number of SMEs mainly in the OECD economies and in some emerging economies, where high-tech or knowledge-based SMEs have become global export performers. Some of them have even become small TNCs in their own right (Fujita 1998), investing in overseas markets either to produce locally or to develop high-skill after-sale services close to clients. Such SMEs, primarily family-owned, have capitalized on impressive accumulation of experiences and know-how. However, there is no consensus on the conditions explaining how SMEs in developing countries such as Brazil, India, the Republic of Korea and South Africa could themselves become outward investors, and the issue should be investigated further.

- SMEs may also access external markets by exploiting the opportunities that inward FDI or large local firms can offer them to engage in indirect exporting activity. In order to enhance their export capacity, SMEs can link up with TNCs or large domestic exporting firms and thereby integrate into global chains of production. This group of SMEs – mainly located in OECD and (to a lesser extent) East Asian countries and more marginally in Latin American countries – has been growing in recent years, especially with the phenomenal growth in FDI registered since the beginning of the 1990s and the growing role of TNCs in world production and trade. In the case of LDCs, it is far more difficult to trace such SME internationalization patterns, owing to the scarcity or absence of FDI in most of them (apart from FDI targeting local commodities and natural resources) and to the unavailability or low quality of data on local SMEs in general and exporting ones in particular.

- Clustering and networking also have the potential to facilitate SMEs' ability to access external markets and compete on an equal footing with larger companies. Inter-firm collaboration, which includes a more efficient division of labour, can lead to greater specialization among small firms, opening opportunities for economies of scope and scale. Networks of mainly small firms, collaborating through specialization and subcontracting, have been the key to the success of many industrial districts in developed countries (e.g. Italy). In some developing countries, there are similar success stories in sectors such as ceramics, garments, leather and shoes, automotive and electronic components.

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[3] The general understanding of independent SME is the one that is not controlled by other enterprise(s) which is (are) not SMEs. The control is the power of an enterprise to exercise a dominant influence over another enterprise pursuant to the owning of a significant capital share or to a contract entered into with that enterprise or to its memorandum or articles of association.

B. The strategic role of TNC-SME linkages

17. Developing countries can succeed in complex industrial exports without going through TNC networks if they are able to build the necessary indigenous base of technological capabilities, as the examples of the Republic of Korea and Taiwan Province of China have shown. However, the changing international context, the growing role of TNCs in world production and trade, and the rising number of SMEs included in international chains of production at various stages of added value may suggest that much of the growth of exports in the future will be situated in or around TNC production systems.

18. Consequently, there has been a paradigm shift in the approach towards SME internationalization. While in classical SME economics one used to say that the more autonomous a small firm was, the better, SMEs in the developing world are now “invited” to grow through dependent and interdependent linkages with larger firms and conglomerates. In other words, though the classical approach has not been radically challenged by globalization – especially given that it still concerns a very limited number of SMEs in developed countries and even more so elsewhere – the autonomy of SMEs is no longer perceived as a panacea.

19. UNCTAD has a leading role in analysing the impact of FDI on the export competitiveness of domestic firms (UNCTAD 2000a, 2000b, 2001b). The major argument is that FDI and business linkages play a more important role globally and should be able to gradually enhance the production capacity of local firms in developing countries, including the SME sector or at least its most promising segments, as is already the case in the OECD and some emerging economies. These linkages could be a way for SMEs to access certain critical resources, the most important of which are access to international markets, finance, technology and managerial skills.

C. Inward FDI and SMEs’ linkages with TNCs: potential benefits and costs

20. Four main types of linkages between TNCs and SMEs have been categorized and analysed by UNCTAD: backward linkages with suppliers, forward linkages with customers, linkages with technology partners, and other spillover effects. Each linkage may have very different impacts on the development of the host country and its local SMEs. Backward linkages with suppliers have been identified as the ones that may have the deepest impact but are the hardest to promote (UNCTAD 2000b). The rest of this section will deal with this type of linkages.

21. The main benefits of outsourcing for foreign affiliates, or even for TNCs at headquarters, include, first of all, the timely availability of supplies, a factor that has become very important in a world with just-in-time production methods. In addition, in host economies with low labour costs and high duties on imports, sourcing from local suppliers can substantially lower production costs. Where suppliers are technologically advanced, they can enable foreign affiliates to concentrate more effectively on core competencies, which increases the competitive benefits of having local efficient support firms. TNCs depend on quality and standardized supplies, and the existence of national or subregional supply clusters is of growing importance in their investment and location decisions (Markusen 1996, Wheeler and Mody 1992). Sometimes, a “reverse transfer” can be also possible, in which TNCs learn from specialized and knowledge-based SMEs (Willem Te Velde 2002, Chew and Yeung 2001). Strong linkages with local SMEs can also enhance the corporate image of TNCs and thus are conducive to their sustainable development.

22. Domestic suppliers can also benefit from linkages with foreign affiliates. A direct benefit is a positive effect on output and employment in linked supplier firms. Indirect effects, which often entail an exchange of information, technical knowledge and skills, may in some cases be more important. UNCTAD has shown how TNCs and their affiliates have developed integrated business-to-business

(B2B)[4] strategies, providing suppliers and subcontractors with various modes of technical, human and financial support (UNCTAD 2000a, 2001b).

23. However, the potential of business linkages to contribute to real local SME development is not realized automatically. Not all linkages are equally beneficial to the host economy. Exclusive linkages within established chains of production can lead to anti-competitive practices and unfair conditions for local SMEs. Suppliers of sophisticated, high-value-added products or services are generally better placed to benefit from linkages. Low-cost suppliers of simple and price-sensitive goods with limited technological and management capabilities may be forced to bear high risks, such as the possibility of facing anti-competitive practices, unequal bargaining positions, excessive dependence and the bankruptcy threat in sectors or subsectors where foreign affiliates are "footloose" and liable to shift to lower-cost locations as soon as wages start to rise. Moreover, outsourcing may be used as a way to transfer social and environmental pressures to supplier firms in locations where labour and environmental standards are lower (UNCTAD 2000a, 2001b).

24. Foreign affiliates' activities do not always signify transfer of technology and know-how to the host country. In several Latin American countries, acquisitions by TNCs or affiliates of privatized enterprises in the telecommunications and energy sectors have caused the decrease – or even the closure – of engineering SMEs and other types of national business support providers (Katz 1999).

25. These different impacts of FDI and linkages on the host country derive from the fact that outsourcing practices differ depending on industry and host country characteristics as well as on TNCs' attitudes towards subcontracting production of inputs to local firms. Because of knowledge and productivity gaps, local suppliers may not have the capability to meet the needs of TNCs. The quality of FDI may also play an important role in sustaining the development of SME suppliers and subcontractors. Moreover, business linkages may happen to be more feasible in some high-tech industries than in others. So far, studies have largely concentrated on the automotive and electronics industries. These two sectors are growth engines for various large and small firms both in developed and developing economies. It remains to be explored whether similar linkages should be encouraged and more systematized in other sectors. For instance, agri-food can play a central role in economic take-off and poverty alleviation in most locations, and especially LDCs. Other areas such as commodities, energy and other natural resources may be less open or linkage-ready for such arrangements. Therefore, national policy may play a transitory corrective or counterbalancing role in addressing such divides and gaps.

III. POLICY RECOMMENDATIONS FOR THE DEVELOPMENT OF SME EXPORT COMPETITIVENESS

26. The changing international context has raised new challenges for policy makers in the developing world, different from those faced by East Asian economies when they began promoting the competitiveness of national enterprises. A number of the direct measures used in the past (such as trade restrictions, monitoring of FDI inflows, and local content requirements imposed on foreign affiliates) are being phased out as a result of the decline of interventionist policies and the rules agreed in the context of the World Trade Organization and other international agreements.

27. During the 1990s, a consensus emerged regarding the fact that:

- Private market and export-led strategies can contribute to industrial take-off and rapid growth in developing countries, including their SME sector, as in some East Asian economies.

[4] Involves businesses selling products or providing services to other businesses.

- A flexible combination of state intervention and market freedom, open trade and selective transitional protection, together with a finely tuned mix of macro and micro policies and public-private partnerships is needed for the development of local entrepreneurship and the creation of dynamic exporting SMEs.

28. Consensus also exists on the need for the involvement of various stakeholders to different degrees in enhancing the export competitiveness of SMEs in developing countries. These stakeholders include governments, the private sector and the international community. Drawing from the experiences of countries that have successfully promoted the export competitiveness of SMEs, this paper makes policy recommendations to these different stakeholders.

A. Policy recommendations to governments

29. **Declaration of a commitment to the export competitiveness of SMEs:** The existence of a clear and strong governmental commitment to supporting domestic SMEs with potential to export directly or indirectly through linkages could give a positive signal to potential investors.

30. **A coherent policy framework:** The design of a coherent policy framework to foster investment, competition, technology transfer, and SME development would require that sectoral and firm-level policies to promote export competitiveness be consistent with policies implemented at the national level (e.g. those related to macroeconomic stabilization, taxation, trade liberalization and business-related regulations). Fundamental policy changes may even threaten the survival of SMEs if the latter are not given sufficient time to adjust and measures are not implemented to facilitate their adjustment, as the experiences of many developing countries and economies in transition with structural adjustment and trade liberalization measures have shown. Moreover, economic and financial safety nets should be put in place to prevent devastating effects on SMEs of macroeconomic and financial disruptions like those during the recent East Asian or Argentinean crises.

31. **Creating a business-friendly environment for SMEs:** The creation and further development of a business-friendly environment enabling SMEs to start exporting, or to help consolidate the activities of SMEs that are already exporting, is critical. This implies:

- Simplification of import-export policies and procedures;
- Combating of corruption and red tape that hinder the growth and export potential of SMEs;
- Creation or reform of administrative and legal institutions in order to guarantee SMEs a stable legal framework in which to operate, and to facilitate an anti-monopolistic and competitive business environment;
- Delivery of an appropriate public infrastructure, especially in transportation, power, telecommunications and other infrastructure needed to enable domestic and external trade (e.g. testing and certification laboratories). When public utilities services are provided by private enterprises, as is actually the case in most countries, emphasis may be on strengthening regulation and anti-monopoly agencies.

32. **A policy of constant improvement of comparative advantages in attracting FDI:** Developing countries should avoid relying exclusively on low wages and should encourage a progressive building-up of knowledge-based local advantages in order to improve advanced and specialized factors of production and to achieve technological goals through linkages with foreign affiliates. Comparative advantages in attracting capital through the low cost of unskilled labour may disappear when other countries offer lower labour standards, or with the appreciation of the national currency. Subsidies draw off resources from other activities and may lead to a subsidy race among competing locations without helping to improve the underlying factors of competitiveness. Low-quality FDI involves firms having few linkages with the domestic sector, low potential for technology spillovers and short-term horizons (UNCTAD 2001b).

33. **Targeting export-oriented TNCs and SMEs:** The choice of exporting SMEs to be supported and TNCs to be attracted should be related to the development objectives of the country, rather than providing indiscriminate assistance to SMEs and/or attracting FDI in general. Targeting should not be a one-off initiative but a strategy that needs to be reviewed over time based on evolving market conditions and private strategies. Targeting involves risks related to the government's ability to foresee which types of domestic enterprises and FDI are likely to have the most favourable impact on national export competitiveness. To mitigate such risks, it is necessary to promote continuous dialogue among stakeholders; create a consensus among national entrepreneurs, trade unions, policy makers and civil society; and integrate policies to promote exporting SMEs and to attract FDI into a comprehensive national development strategy (UNCTAD 2002a).

34. **Incentives or subsidies to support exporting SMEs:** The provision of direct support to some SMEs may be considered in order to get them export-ready and/or to link them up with domestic or foreign partners. Such measures can take a number of forms:

- *Direct incentives or subsidies.* Fiscal and other financial incentives seem more market-friendly, feasible and performing, especially in developing countries with limited budgetary and fiscal resources. Subsidies hardly work, with the exception of some direct forms of support such as helping SMEs to gain access to distant trade fairs or to specific sources of market-matching information. The international legality of incentives and subsidies is discussed below in section III.C.
- *Indirect incentives or subsidies to facilitating public and/or private institutions as well as to SME export business facilitators.* However, experience has shown that in many developing countries, public export promotion agencies lack professional capacity as well as credibility and visibility among most SME entrepreneurs. Therefore, governments and international donors should consider funding public or parastatal agencies, especially where such facilitating institutions hardly exist in the private sector, as is the case for many developing countries, owing to low demand for such services by local businesses.

35. **Measures to improve exporting SMEs' access to finance:**

- *Establishing, together with the respective central banks, a policy framework for channelling adequate funds to exporting SMEs.* This may include: providing credits directly from state-owned banks to SMEs; liquidity incentives to commercial banks that provide loans to SMEs (lowering of reserve requirements, access to discount lines, etc.); interest rate subsidies; guarantee programs; and so forth.
- *Improving the bargaining position of SMEs vis-à-vis large conglomerates of which they are suppliers.* This may include measures such as providing legal assistance to suppliers negotiating contracts, providing legal protection against unfair practices, shortening payment delays for local suppliers through legislation or fiscal incentives, and encouraging the provision of financial support by big firms to their SMEs suppliers through fiscal incentives.

36. **Measures to encourage TNCs to create linkages with SMEs:** Provided the local suppliers' capacities are sufficient to meet the needs of foreign investors efficiently, these measures include:

- *Prescriptive measures like high tariffs on imports, local content requirements, or rules of origin.* However, these types of measures are being phased out as a result of host countries' policy changes to more market-oriented economic strategies, and also owing to international commitments, in particular the WTO TRIMs Agreement.
- *Incentives.* These include benefits such as tax exemptions, the possibility to treat costs related to linkages formation as tax-deductible expenses, and granting foreign investors a special status that entitles them to various types of fiscal or financial incentives. However, care must be taken to make the use of incentives compatible with international commitments (such as the TRIMs Agreement and the Agreement on Subsidies and Countervailing Measures) and to

avoid granting incentives in situations in which linkages would be forged even in the absence of such incentives.

- *Contractual arrangements with foreign investors, such as privatization transactions and licence concessions.* These may offer host governments opportunities to encourage the formation of local linkages by including this element in the negotiation process (UNCTAD 2001b).

37. **SME trade promotion through public-private partnerships:** The promotion of public-private partnerships is a more recent approach to linking together various types of economic and non-economic agents. Governments may approach domestic and foreign large corporations to design specific institutions or tools to provide exporting or promising SMEs with specific services. Such partnerships can take various forms, including training facilities, technology upgrading centres, research and testing labs, scientific hubs, investment funds, start-ups, incubators, and so on. Local governments and municipalities can also play a role in supporting the wider spectrum of local SME entrepreneurs, encouraging the creation of start-ups, developing their awareness of new external business challenges, upgrading them to become internationally competitive, and linking them up with larger economic agents of domestic and foreign markets. Such interventions should not be only declaratory and concentrated in the capital city, but should also reach SMEs in all provinces and districts through strengthening of the business promotion activities of meso- and micro-institutions.

38. **Measures from governments of home countries to increase the benefits of FDI:** The São Paulo Consensus, reached at UNCTAD XI by representatives of all member countries, stresses the importance of home-country policies and measures to encourage investment and technology transfer and to maximize the benefits of FDI in the host economy. These measures include the collection and dissemination of information related to investment opportunities in developing countries, the encouragement of technology transfer, the provision of various forms of financial and fiscal incentives, and help with mitigating risk by providing insurance that may not normally be covered through the private market (UNCTAD 2004b).

B. Recommendations to the private sector

39. A wide range of measures could also be considered at the B2B level to boost the export capacities of SMEs in developing countries. Key actors and possible measures include:

40. **Trading houses:** Trading houses, which control vast trading networks and distribution channels across borders, can do more to encourage the export activities of SMEs from developing countries. They can provide SMEs with various forms of marketing assistance and facilitate access to market and product information and quality imports. Furthermore, they can provide SMEs with the trade documentation, insurance and credit needed to trade successfully. They can also give SMEs access to long-term credit to upgrade production and technology. Trading companies may even consider investing in a promising SME for the sake of diversifying their own activities and/or producing locally in order to export profitably. Trading companies should source more from SMEs and should consider establishing themselves in more developing countries, particularly LDCs.

41. **TNCs:** In manufacturing, TNCs and their foreign affiliates can do more to drive or guide the competitiveness upgrading of selected local SME suppliers and subcontractors. While direct investment into these SMEs will be rare, B2B linkages will take other routes through various transfers of know-how. Socially responsible TNCs should pay more attention to the trickle-down effects of their local business activities. They should act more responsibly not only vis-à-vis their direct SME counterparts but also where economic, educational, technological and social conditions remain marginal.

42. **SMEs that are already suppliers of TNCs:** SME suppliers working closely with TNCs tend to invest in those regional or subregional hubs where TNCs operate. By doing so, such SMEs are

sourcing themselves from local SMEs, which in turn can benefit from their know-how. The possible deepening of such SME interlinkages has not yet been studied extensively. TNCs and foreign and local governments should analyse what types of public-private vehicles could facilitate such interlinkages.

43. **Clusters:** As was mentioned in paragraph 21, clusters and districts could enhance SMEs' ability to compete in the global economy through a semi-collective organization and specialization among SMEs. National governments, local authorities, TNCs and SME associations should be involved in efforts to identify the optimal division of labour among individual SMEs, large firms and central/local governments in developing countries so as to enable replication of the successes of the best exporting SME clusters and industrial districts (like those in Italy and Taiwan).

44. **Business associations:** There are few specific and representative SME associations in developing countries, and even fewer that focus exclusively on the SME import-export business. SMEs should become more active participants in business associations, chambers of commerce and employers' unions, and the efficiency of such institutions as it relates to the promotion of SMEs should be a focus.

45. **Financial and non-financial business development services (BDS):** Smooth access to financial and non-financial services can play a role in supporting some SMEs aiming to export or to consolidate regular foreign orders. Except in some LDCs, the development of highly skilled BDS to meet the financial and technical/training needs of exporting SMEs is primarily market driven, and a majority of such services are private, whether independent or incorporated into large manufacturing or tertiary firms. On the non-financial front, exporting SMEs are often ready to pay for good quality and specialized technical services in areas like foreign market and product information, design and patterns, appropriate machinery and technology, skilled training, quality control, norms and testing, marketing, conditioning, packaging, communication and advertising, transport and freight, after-sale service, intellectual property rights and other contractual issues, and the like. The local availability of BDS may enable a small firm to focus on the quality of its production and on its own internal organization and management. In case of non-availability, foreign buyers and manufacturers and/or national governments and international donors could fill the vacuum.

46. **Combination of financial and non-financial support services:** The rigid separation between financial and technical service providers should be reduced to improve proximity to the real multi-level needs of SME exporters. Ways and means but also willingness should be mobilized within the private sector, but also with the pressure and participation of governments and donor agencies, in order to be able to make serious and effective cross-evaluations of exporting SME clients. To achieve this, financial institutions should rely on the expertise of technical service providers to assess the credibility of an exporting small business, not only on its financial accounts and its proposed collateral to support a credit demand. Credit risk, transaction costs and therefore interest rates can be reduced if financial institutions are ready to develop a working relation with BDS providers able to evaluate the profile of each individual SME. The combination and teamwork of financial and technical services should be much more systematically explored both by banks and by BDS providers to match SME export needs.

47. **Commercial banks and informal credit groups and institutions:** Foreign banks and their large corporate clients (domestic companies and TNCs) could issue international credit guarantees to SMEs already engaged in quality exports and other SMEs well known to them. In some developing countries, if the lack of access to banks tends to persist, exporting SMEs can get started by themselves or become members of informal credit groups. Informal credit institutions have sometimes grown as big as formal banks.

C. Recommendations to the international community

48. **TNCs' corporate responsibility and business linkages for exporting SMEs should be part of the UN Global Compact agenda:** During the 1990s, the issue of the corporate responsibility of TNCs first emerged under the theme of their global environmental and social responsibility. More recently, the concept has been interpreted internationally in a more diverse and broader developmental sense since the launch of the UN Global Compact in 2000.[5] TNCs and other large firms could play a more driving role in enhancing local SME development, and SME export competitiveness in particular, through various forms of FDI and business linkages. In order to better exploit the benefits of globalization but also to cushion its potential negative effects, the international community, together with large firms, should develop public-private partnerships to the real benefit of SMEs in developing countries. It would thus contribute to greater economic and social security at the local community level. Such partnerships should also aim to improve the decency and quality of labour in local SMEs – not only in the ones directly linked to foreign buyers and investors, but along the entire production chain, from the global to the local level.

49. **National policy versus international commitments:** An important issue that should be given special consideration by the international community is the policy autonomy that national governments have to support their domestic industry, in particular SMEs. Specific and transitory national policies could be considered either to promote local SMEs' gradual integration into global chains of production whenever possible or, in other cases, to protect them selectively from overly fierce global competition. In the choice between incentives and subsidies for exporting SMEs, their compatibility and legality with existing international agreements needs further exploration.

50. **SMEs' access to finance:** The international community should play a more active role in facilitating SMEs' access to finance. This can be achieved in the following ways:

- **Enhancing SME export credit and long-term finance under the new Basel II regime:** The international community should help in the collection of the best practices of national and international finance institutions in facilitating SME access not only to short-term export credit but also to long-term loans for the expansion of SME export capacity. The issue of credit collateral and guarantees should be revisited. Foreign buyers, TNCs and other business linkage makers should be invited as facilitators or guarantors. The sensitive issue of the Basel II accord under the Bank for International Settlements (BIS) should also be examined in relation to industrial and SME policies. Developing countries fear that the imposition of higher and more restrictive lending ratios on commercial banks will have some negative impacts on the already limited capacity of local banks to lend to SMEs.

- **Coordination between financial and non-financial support institutions:** The international community could directly support or call for the multiplication of pilot experiences in this area, such as the Empretec Ghana Foundation (EGF). This UNCTAD programme in Ghana has expanded its portfolio of BDS to include financial services and operates four schemes to facilitate access to credit for SMEs: credit sourcing to provide loans to micro- and small enterprises; a mutual guarantee scheme in which SMEs mutually each other's bank borrowing on the basis of a fund created by regular joint contributions; agreements with selected financial institutions to enable SMEs to quickly access medium- to long-term finance at preferential interest rates; and export development and investment funds (EDIF) designed to improve the export competitiveness of SMEs at low comparative interest rates (UNCTAD 2003c).

[5] The Global Compact seeks to advance responsible corporate behavior so that business can be part of the solution to the challenges of globalization. In this way, the private sector – in partnership with other social actors – can help create a more sustainable and inclusive global economy.

- **Improvement of the SME finance programmes of multilateral financial institutions:** The SME finance programmes that these institutions have developed through national ministries of finance and central banks should be improved in the following ways:

Box 1
PROEX-EMPRETEC: Supporting Domestic Companies' Efforts to Achieve Export Competitiveness

PROEX is an export support programme carried out by Empretec Uruguay in collaboration with UNCTAD, the Inter-American Development Bank (IDB) and Banco de la República Oriental del Uruguay. With methodologies acquired from Consorcio de Promoción Comercial de Cataluña (COPCA), the government agency for the internationalization of Catalan enterprises, Empretec Uruguay selects and trains companies with the objective of helping them developing the necessary capabilities to become exporters. The objective of the programme is to assist participating companies not only by making them export-ready but also by engineering a permanent change in their corporate perspective and strategy.

Each company relies on the assistance of a foreign trade expert. The whole process lasts 18 to 24 months and comprises three phases:

Phase 1: *Diagnosis:* Evaluation of the company's strengths, weaknesses, opportunities and threats in view of its strategy of entry into foreign markets.
Phase 2: *Export plan:* This is the core element of the PROEX system. It involves defining all elements, measures, means and targets related to developing export activity, from identifying the product or products to be exported to defining the payment methods.
Phase 3: *Plan application and monitoring:* The steps defined in phase 2 are put into practice, monitored and adapted to market realities.

According to the evaluation report produced by Empretec Uruguay, the project achieved successful outcomes: the number of participating enterprises was 83 (instead of the expected 40); 16 consultants were trained (instead of the expected 10); 73% of the companies started exporting; 82% of the companies produced a new catalogue, website or electronic catalogue; 74% of the companies created an export department; and 90% of the companies have a positive opinion about the programme.

Sources: Emprețec Uruguay (2003), Evaluación de Término de programa Proex-Empretec [Final evaluation of Proex-Empretec programme], evaluated by Enrique Baraibar, September; Empretec site *www.empretec.net* (2004).

- Whether and to what extent these programmes include SME export competitiveness and financing, and the lessons thereof, should be examined.
- Multilateral finance could play a bigger role in facilitating SME export finance in the framework of existing interregional, regional and subregional trade agreements.
- The IMF/World Bank Group and governments could further explore the economic and social need for temporary SME export safety nets, especially when global and/or national financial markets fail, as happened in the recent crises in Argentina, East Asia, Russia and Turkey.

51. **Other fields where the international community has a role to play:**

- **South-South trade:** Encouraging South-South outward investment, and helping SMEs in developing countries develop South-South trade, including transborder and small-scale transactions among LDCs, with possible technical support from TNCs and other large firms operating in the neighbourhood.

- **Trade infrastructure:** Supporting public-private partnerships in cofinancing trade infrastructure in developing countries.

- **Trade barriers:** Removal of remaining trade barriers, including tariffs on products from LDCs and protectionist measures vis-à-vis offshoring of services.

- **Training programmes:** Providing or cofinancing specific entrepreneurship training programmes focused on picking up the most promising SMEs in order to get them export-ready (see box 1). Within such programmes, there is a need to create awareness of the growing importance of intellectual property rights for exporting SMEs.

CONCLUSION

52. This paper has analysed how to promote the export competitiveness of SMEs in developing countries and has identified three ways in which SMEs can access external markets through exports: independent SMEs specializing in specific niches and highly profiled productions; SMEs that link up with TNCs or large domestic exporting firms; and SMEs that are part of clusters and networks in order to reinforce their external competitiveness.

53. Special emphasis has been put on linkages between TNCs and SMEs as a way to enhance the export competitiveness of SMEs, owing to the leading role that TNCs are increasingly playing in world production, trade and finance, and to the rising number of SMEs that are being included in international chains of production. This could suggest that much of the growth of exports in the future will be situated in or around TNCs' systems. Linking up with TNCs is increasingly perceived as a way for SMEs to solve their traditional problem of access to certain critical resources, the most important of which are finance, technology and managerial skills, as well as to new markets. However, while linking up with TNCs can bring benefits for SMEs, it can also entail risks and costs that may need to be addressed through appropriate policies and measures.

54. Promoting the export competitiveness of SMEs needs the involvement, to different degrees, of various stakeholders – governments, the private sector and the international community – in it is to them that the policy recommendations in this paper are addressed.

55. The experts may wish to consider the following issues for discussion:

- Does globalization raise new challenges for SMEs' export competitiveness?
- Should SMEs' export capacity be spontaneous or promoted?
- Is SMEs' domestic competitiveness a precondition for export competitiveness, and does it automatically lead to an increase in the national export capacity?
- What types of SMEs are more export-oriented and can more easily become partnership-ready? How is it possible to quickly meet international technology and quality standards?
- Can linkages with TNCs help to promote the export competitiveness of SMEs, and how can corporations contribute to this objective?
- Are the policy recommendations included in this paper sufficient to address the issue of the export competitiveness of SMEs?

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