December | 2016

CUTS International GENEVA

Note

Integrating Micro, Small and Medium Enterprises in International Trade

A Brief Analysis of Challenges and Opportunities

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Summary

This note explores the benefits and barriers of engaging with international trade through the lens of small and medium enterprises (SMEs) as well as micro, small and medium enterprises (MSMEs). It concludes with some possible solutions that could result in addressing the barriers and better integration of SMEs and MSMEs in the global economy.

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Introduction

Globally, small and medium enterprises (SMEs) as well as micro, small and medium enterprises (MSMEs) are the leading providers of employment and contribute significantly to value addition. Despite their importance, SMEs and MSMEs are faced with numerous challenges that hinder their integration in international trade. Never the less, given their potential, there's increasing attention from international, regional and national trade and related institutions to leverage these firms for economic development, employment and improvement of livelihoods by effectively integrating them in international trade.

It is estimated that about 20 percent of new SMEs and MSMEs go out of business after their first year, and that over 50 percent eventually windup after five years. It is also established that SMEs and MSMEs involved in export trade are more sustainable and more likely to survive, which calls for policy action that creates and enhances an enabling business environment to this end.

Within the World Trade Organization (WTO) the potential role of SMEs and MSMEs has been recognised and there are ongoing consultations on how their participation in international trade can be enhanced. It is in this respect that this brief note analyses from literature review, the core principles for promoting participation of SMEs and MSMEs in international trade.

Although there is no precise and universally agreed definition of SMEs and MSMEs, countries – according to level of development- use several attributes to categorise entities. The commonly applied standard considers number of employees, sales turnover, and profitability of firms. In developing and least developed countries majority of firms are in the SMEs and MSMEs category, hence the need for policies that priorities their development. This is necessary for the firms to overcome prevailing challenges and leverage the potential to grow by better integrating in national, regional and international trade.

Opportunities and Challenges for Integrating SMEs and MSMEs in International Trade

Opportunities

Advancements in communication technologies and ever-growing globalization in the last two decades or so have created new opportunities for SMEs and MSMEs in the global economy. E-commerce and ICT services reduce the costs of trade by lowering transaction costs and by enabling firms and their clients to communicate more effectively and faster with one another. Today, SMEs and MSMEs can offer their products and services to more potential customers worldwide, using Internet and e-commerce platforms such as e-Bay and Alibaba. Access to ICT-enabled services, increase the possibility of engaging with trade for businesses. The WTO World Trade Report (2016) states that "On average, 97 percent of internet-enabled small businesses export."

The ICT revolution has also raised the trade in

Global Value Chains (GVCs). The emergence of GVCs allows companies to be specialized in a small part of the supply chain, giving SMEs and MSMEs more avenues to participate in international trade. For small firms in LDCs and developing countries being able to trade internationally through GVCs, means that they can engage in business activities and tasks in which they have a comparative advantage, and to overcome their knowledge gap. In addition, trade in GVCs allows SMEs and MSMEs to access more clients, more market information, and larger cash flow[1].

Trade can also improve the quality of SMEs and MSMEs products and services because of consumer preferences, especially when companies from developing countries and LDCs export to developed countries where the demand for high quality goods is more than other markets, and there are well-developed consumer protection standards in place.[2]

Improvement in productivity is another positive aspect of engaging in international trade for SMEs and MSMEs. A study by Vogeland and Wagner (2010) illustrates that there is a direct correlation between engaging in trade and productivity. And firms that export are more productive and pay higher wages compared to firms that serve only the national market. According to Kasahara and Rodrigue (2008), the data on Chile indicates that being an importer of foreign intermediates can significantly improve productivity. Amiti and Konings (2007), explore the impact of importing intermediates input on developing countries and suggest that it can be an important source of bringing advanced technologies to developing countries. In addition, productivity leads –through learning effects- to more innovation which is an important tool for SMEs and MSMEs to expand internationally[3].

Access to a larger market, enhanced productivity, technology upgrade, and higher quality of products and services are all the benefits of engaging in trade for SMEs and MSMEs.

Challenges

Despite all the discussed advantages that engaging in international trade bring for SMEs and MSMEs, the participation of them in the global economy remains relatively weak.

SMEs and MSMEs, by nature, focus more on their domestic markets rather than international ones. This tendency can be explained by the fact that SMEs and MSMEs face many challenges when it comes to exporting and investing internationally[4]. A report by Asia-Pacific Economic Cooperation (APEC) states that in the APEC region, between 1990 and 2000, 98% of firms and 60% of jobs were created by SMEs, while the same SMEs contributed only in 30% of exports and 10% of FDI[5]. There are several factors that limit the access of SMEs to world markets, including lack of financial resources, trade policy-related issues, lack of access to information due to costs and poor communication infrastructure, and lack of

[1] The WTO (2016), World Trade Report – Leveling the trading field for SMEs

[2] Ibid.

[3] The WTO (2016), World Trade Report – Leveling the trading field for SMEs

[4] IMD (2006), Trade and SMEs

[5] APEC (2003), Profile of SMEs and SME Issues in APEC 1990-2000.

resources to cope with bureaucratic procedures and regulatory burdens[6].

Insufficient financial resources make it difficult for SMEs and MSMEs to overcome the costs of entry to international markets. Only the most productive firms can afford the expenses of getting into a new market. Examples of such costs - also known as beachhead costs - are setting up a distribution network, complying with regulations and obtaining patents and licences[7].

When SMEs and MSMEs turn to banks and other financial institutions to raise capital, they face another obstacle: higher costs of borrowing money compared to larger firms. SMEs and MSMEs often do not meet the core requirements of lending money, including sufficient collateral and the proof of firm's past business and financial records. Beck et al. (2008) indicates that access to external finance is a key element of a firm's growth- especially for SMEs- and that small firms tend to use less external finance. As a result, SMEs and MSMEs rely more on their internal or informal resources to fulfil their financial needs, which often results in missed economic opportunities[8].

As discussed, online trade is an important tool for SMEs and MSMEs to expand their business worldwide. Today, broadband internet is an essential part of conducting business over internet –especially when it comes to trade in services and business processing outsourcing. Broadband technologies provide the speed that is needed to use new internet-based technologies such as cloud computing or file sharing services that require transferring large files over data networks[9]. Rick (2014) shows that increase in access to broadband technologies will lead to more involvement with trade. That being said, a well-developed ICT infrastructure is vital for SMEs and MSMEs to fully benefit from engaging in online trade. However, there are different levels of access to ICT services in developed and developing countries. ITU data shows that access to fixed broadband internet is only 0.5% in Africa compared to 29% in the developed world. The data shows that access to mobile broadband services in Africa is 17.4% which is way below 86.7% in developed countries.

In addition, the price of ICT services is as important as the availability. In Africa, despite the high penetration rate of mobile phones compared with fixed services, the average cost of access to mobile services is 16% of gross national income (GNI) which is significantly higher than 1% in Europe[10].

Apart from availability and price of ICT services, there are other barriers that limit SMEs and MSMEs to engage in online trade. For instance, e-commerce platforms do not always operate in all geographical regions. They may buy from and sell to only certain countries. Moreover, restrictions on financial transactions and difficulties when transferring money electronically, lack of information about companies and how trustworthy they are, and concerns about cybercrimes, create another set of challenges for SMEs and MSMEs – mainly in developing and least developed countries- and

[6] IMD (2006), Trade and SMEs
[7] The WTO (2016), World Trade Report – Leveling the trading field for SMEs
[8] The WTO (2016), World Trade Report-Leveling the trading field for SMEs
[9] Ibid.
[10] Ibid.

prevent them to effectively conduct online trade[11].

Among trade policy barriers, tariffs seem to have the biggest impact on SMEs and MSMEs. For small firms, it is less profitable and feasible to export to a market with a high tariff regime. Only the more productive firms can export to such countries. Tariffs also affect the volume of export of firms. Small companies are more sensitive to price fluctuations and they usually look for the ways in which they can deliver their products and services to their target market as cheap as possible[12]. As a result, high tariffs regimes can significantly increase the price tag of their products and services and make them less competitive in the foreign market.

Non-tariff barriers such as Non-tariff Measures (NTMs) also reduce the ability of SMEs and MSMEs to export. For instance, a firm may need to pay a large fee to obtain a certificate or to comply with a certain standard requirement. According to a study by the International Trade Center (ITC) (2015), small firms in developing countries are the most vulnerable to NTMs. Pre-shipment requirements in the export market and weak inspection procedures at the exporting country seemed to be the main barriers[13].

In addition to regulatory and market access barriers, SMEs and MSMEs can face other trade costs that limit their operations in target markets. Distribution network costs are one example. For SMEs and MSMEs it is important to access distribution networks so that they can reach out to their clients more effectively. However, there are some costs associated with efforts to manage a well-functioning distribution network. For instance, SMEs and MSMEs usually rely on available logistic services, such as postal services, in export markets to deliver their products. Other logistical operations add up to distribution network costs, including pick-up of goods, customs clearance and warehousing.

Gathering information about target markets, which is an important component of managing a distribution network, is also costly. Firms that want to expand their operations in a new markets need to know about regulatory procedures and the characteristics that their products need to meet in the market that they intend to export[14]. Anderson and van Wincoop (2004) study shows that on average 6% of total trade barriers are trade costs. Lack of knowledge about regulations could lead to, for instance, conflicts at customs and result in returning the goods and profit lose.

Conclusion and Suggestions

For SMEs and MSMEs, being able to engage with international trade is a double-edge sword. On one hand, trade opens their way towards more business opportunities beyond their domestic market and allows them to be more innovative, productive and to reach out to more potential clients; and eventually benefit from more income. On the other, international trade raises a set of barriers that make it difficult for small firms, with limited financial, technological and market access resources, to serve

[11] The WTO (2016), World Trade Report-Leveling the trading field for SMEs
[12] Ibid.
[13] Ibid.
[14] The WTO, World Trade Report 2016-Leveling the trading field for SMEs

international markets.

As discussed, major trade barriers for SMEs and MSMEs are lack of financial resources, trade-policy related obstacles and lack of access to information and ICT-enabled services. However, various methods can be used to reduce the effect of these barriers on internationalization of SMEs and MSMEs.

As we mentioned, SMEs and MSMEs often do not meet the core requirements of lending money, including sufficient collateral and the proof of firm's past business and financial records. However, banks and other financial institutions can play an important role to develop financial packages that are more in favour and supportive of small businesses.

In recent years, banks have started to see the SMEs and MSMEs sector as a strategic investment target. The data suggests that for many banks, SMEs and MSMEs are becoming a niche market and that the market for SMEs and MSMEs is becoming more competitive, with profitable growth forecasts. As a result, banks are developing new business models and risk management systems to better serve SMEs and MSMEs. One method is to recognize productive and promising SMEs and MSMEs through their performance in the supply chain of bank's large corporate clients[15]. In addition, in the global level, international financial institutions such as the World Bank and IMF can use their advocatory approach to further promote the importance of providing SMEs and MSMEs-friendly financial products and services.

Trade policy barriers can be reduced through bilateral and multilateral trade agreements. A bold example is Trade Facilitation Agreement (TFA). It offers an effective mechanism that significantly reduce costs of regulatory and market entry for companies – especially SMEs and MSMEs. Such efforts that ease the process of getting access to international markets for businesses of all sizes could be more advocated in international dialogues between different stakeholders and through organizations such as the WTO and the UN.

ICT-related barriers can be addressed through (1) improvements in the quality of ICT infrastructure – especially broadband services, (2) well-developed data and intellectual property protection policies, (3) affordable prices for ICT-enabled services –particularly in developing countries and LDCs, and (4) enhancements of domestic and international payment mechanisms. Further consideration in each of the ICT-related barriers can be achieved through promoting domestic and international conversations –especially in the sphere of trade in services- led by states, private sector and international organizations such as ITU.

[15] Journal of Banking and Finance (2010), Bank Involvement with SMEs: Beyond Relationship Lending

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