SMEs, Trade and Development in Latin America: Toward a New Approach on GVC Integration and Capabilities Upgrading

Gerald A. McDermott
Darla Moore School of Business
University of South Carolina
gerald.mcdermott@moore.sc.edu

Carlo Pietrobelli
Inter-American Development Bank and University Roma Tre
carlop@iadb.org

SMEs and Global Markets: The Missing Link for Inclusive Growth
Geneva, 27-28 March 2015
Message of the paper

• Integration in GVCs offers remarkable opportunities: not only easier market access, but notably knowledge flows, technological and learning spillovers and capabilities improvements.

• However GVCs are only an opportunity, insufficient per se, that needs to be exploited.

• Local firms need to be exposed to modern practices and technologies, but often do not have the capabilities to link into and to benefit from

• It is not frontier research and knowledge that matters most, but experiential knowledge and local adaptation and learning.

• MNCs and chain leaders may make this knowledge available, but non-market, private-public institutions may provide the relevant knowledge and training and act as social and knowledge bridges
Plan of the Talk

I. Introduction

II. Regional and Global Integration in South America: Trade and FDI

III. SMEs in South America

IV. SME Support Policies in LAC. Old practices and new trends

V. Conclusions
Introduction

• Although SMEs make up the vast majority of firms in Latin America, their participation in export markets and integration in global value chains (GVCs) is low.
• Increased GVC participation has the potential to:
  – Not only foster access to international markets, with improved earnings and wages
  – But generate knowledge transfer and foster SMEs’ technological and organizational learning and upgrading.
• After two decades of increased economic openness in LAC, the expected benefits of open markets have been small for SMEs.
• Certain types of mechanisms, institutions and policies can improve both SME participation in GVCs and SME competitive capabilities over time.
II. Regional and Global Integration in South America: Trade, FDI and GVCs
Structure of Exports by Sub Region in LAC (2010)

(% of total goods and services exported)

Source: ECLAC, 2014
Exports grew with rising prices, but lower Diversification

• Exports grew steadily from most LA countries between 1990 and 2012, but mainly due to export prices (+8.5% per year, volumes +5.4%).

• However, export basket has become more concentrated in fewer items during last decade.
  – Partial Exceptions are Argentina, Brazil, and Uruguay.
  – In Andean countries in particular, growing export concentration is strongly linked to greater reliance on the expansion of mining, gas and oil industries. For example: Bolivia no gas until 2000; Venezuela oil is now 96% (70% in 1998); Colombia’s oil 65% in 2013 and coffee from 15% to 3%.
Export Market Diversification

- **China** has overtaken the U.S. as the **main export destination for natural resources**. China is the final destination of 25% of Chile’s exports and 19% of Brazil’s total exports.

- Regional markets are more important for small and medium-sized countries, as well as for the southern cone countries.
  - Bolivia exports >50% to Brazil and Argentina.
  - Brazil is top export destination for MERCOSUR members, Argentina and Paraguay (33 and 30%, respectively).
Large FDI Inflows in South America. By Sector (%)

- FDI flows to South America in 2013 = $133 billion USD (3X of SSA but 1/3 of Developing Asia)
  - Brazil, followed by Chile, receives largest share.
- FDI heavy in natural resource based sectors (mining half of 2012 FDI).

Source: ECLAC, 2012
GVC Participation

- Trade in value-added (TiVA) reflects the value that is added by industries in producing goods and services.
- The evidence presented suggests that LAC is less integrated into GVCs than other regions of the world.
  - In South America, a downstream integration prevails, countries export intermediate inputs of other countries’ productions (typically natural resources and minerals, like for Brazil, Chile, and Peru).
  - In Central America and Mexico an upstream specialization prevails with large presence of foreign inputs in overall exports through arrangements such as in-bond assembly.
### Global Value Chains Participation Rates (2011)

<table>
<thead>
<tr>
<th>Region</th>
<th>GVC participation rates</th>
<th>Growth of GVC participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global</td>
<td>57%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Developed economies</td>
<td>59%</td>
<td>3.7%</td>
</tr>
<tr>
<td>European Union</td>
<td>66%</td>
<td>3.9%</td>
</tr>
<tr>
<td>United States</td>
<td>45%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Japan</td>
<td>51%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Developing economies</td>
<td>52%</td>
<td>6.1%</td>
</tr>
<tr>
<td>Africa</td>
<td>54%</td>
<td>4.8%</td>
</tr>
<tr>
<td>Asia</td>
<td>54%</td>
<td>5.5%</td>
</tr>
<tr>
<td>East and South-East Asia</td>
<td>56%</td>
<td>5.1%</td>
</tr>
<tr>
<td>South Asia</td>
<td>37%</td>
<td>9.5%</td>
</tr>
<tr>
<td>West Asia</td>
<td>48%</td>
<td>6.4%</td>
</tr>
<tr>
<td>Latin America and Caribbean</td>
<td>40%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Central America</td>
<td>43%</td>
<td>4.1%</td>
</tr>
<tr>
<td>Caribbean</td>
<td>45%</td>
<td>5.7%</td>
</tr>
<tr>
<td>South America</td>
<td>38%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Transition economies</td>
<td>52%</td>
<td>8.0%</td>
</tr>
</tbody>
</table>

**Memorandum item:**
Least developed countries

- Upstream component
- Downstream component

Source: UNCTAD - EORA GVC Database
III. SMEs in South America
Productivity, exports and GVC integration
Large Gaps in Relative Productivity and Wage between Large and Small Firms (Large firms=100)

Source: Adapted from OECD-ECLAC, 2013

Notes: Wage gap data refers to 2006.

SMEs 99% of all firms, 80% of employment
SME Participation in Exports and GVCs in Latin America

- Only **13% of South American SMEs export directly** (in Asia much higher: Malaysia 55%, Thailand 47%, South Korea 19%).

- **Small Caribbean countries are more internationalized** than South American countries.

Source: World Bank Enterprise Surveys (2010) and WDI
LAC SME Exporters perform well

LAC SME exporters tend to be:

- foreign-owned
- older (16 years or older)
- more productive
- pay higher wages than non-exporter firms

- Strong performing SMEs ‘self-select’ into export markets
- Less productive firms do not have the capabilities or know-how to expand beyond domestic markets (and cannot benefit from exporting either…)

- LAC SME Exporters: narrow exporters as they export:
  - a small number of products
  - to a small number of markets.
Obstacles to SME Participation in Exports and GVCs

Although exports are increasingly made by intermediate products made in third countries. 28% worldwide, 14% in LA) e.g. in Chile in 2010 4,800 SMEs carried out direct export operations, and 33,000 served as suppliers to export companies.

Barriers persist for SMEs to Export Participation:

• Informality, Higher fixed costs and poor credit access, Low-skills, low capacity to meet international quality and technical regulations

Barriers persist for SMEs to GVC Participation:

• Low productivity limits ability to produce the intermediate goods and services with the time and quality standards demanded by lead companies.
• Poor regulatory capacity and poor infrastructures
• Asymmetries within GVCs
• Hierarchical governance offers lower upgrading opportunities
IV. SME Support Policies in LAC. Old practices and New Trends
SME Support Policies

- Low public support for SMEs
- Limited budgets for export promotion agencies
- SME and export support program grew in the 1990s, but focused mainly on employment generation or access to finance.

### Public Support to SMEs (as % of GDP)

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Colombia</td>
<td>0.008</td>
</tr>
<tr>
<td>Uruguay</td>
<td>0.024</td>
</tr>
<tr>
<td>Chile</td>
<td>0.030</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.085</td>
</tr>
<tr>
<td>South Korea</td>
<td>0.270</td>
</tr>
<tr>
<td>U.S.</td>
<td>0.390</td>
</tr>
<tr>
<td>Spain</td>
<td>0.410</td>
</tr>
</tbody>
</table>

Source: ECLAC (2014)
Evolution of SME Support Programs

Some recent policy reforms recognize the relevance of knowledge transfer and capabilities creation for SMEs, and the need to link SMEs into different learning networks (public and private).

1. Cluster development programs
2. Value chain integration programs
3. Move beyond “linkage-enhancing” programs and acknowledge the need for experiential knowledge and private-public intermediary institutions
Cluster Development Programs (CDP)

Rethinking Productive Development
Sound Policies and Institutions for Economic Transformation


Edited by
Gustavo Crespi,
Eduardo Fernandez-Arias
and Ernesto Stein
Cluster Development Programs (CDP)

- Clusters offer great opportunities of coordination but also have externalities that can make coordination harder (Glaeser, 2010). Problems of appropriability of returns may produce low-investment equilibria.
- **CDP promote coordination** among local actors to define shared objectives and joint actions required
- CDP offer opportunities for knowledge and technological spillovers and externalities among the firms
- They help policy-makers “discover” what the key missing inputs are that public policies need to provide.
CDPs in South America

• Very widespread.

• IDB supported more than 300 clusters with about US$ 500 million.

• **Policy tools:**
  
  ➢ Technical assistance to promote coordination and strategic planning

  ➢ Partial grants to help support collective actions to strengthen existing linkages, and establish new linkages.
IDB Cluster programs in Minas Gerais and Sao Paulo (Brazil): Econometric evaluation with DinD of the performance of beneficiary firms in clusters relative to control groups (non-beneficiaries and indirect beneficiaries):

- **Positive direct** and significant effects on:
  - **Employment**: about 20% increase in 3-5 years;
  - **Probability to export**: about +5% for year relative to the original proportion of exporting firms;
  - **Export levels**: between 50% and 80% for each exporter for beneficiary firms. Effects persist and grow overtime.

- **Indirect effects** on firms localized in the area of influence of clusters, especially on the probability to export and less on export levels.

Maffioli, Pietrobelli, Stucchi, 2015, *Cluster programs Evaluation*, Washington DC, IDB, synthesis in

http://publications.iadb.org/bitstream/handle/11319/5960/Evaluating%20the%20Impact%20of%20Cluster%20Development%20Programs.pdf?sequence=1
Case studies suggest that:

- CDPs represent useful tools to coordinate microeconomic policies at the local level.
- They are flexible enough to adapt to local circumstances.
- Through their participatory approach they help to identify (“discover”) the missing public policies and create consensus.
- Many programs created local conditions (“Platforms”) for a better coordination among firms and with public entities.
- “Capture” of subsidies and “rent-seeking” appear to have been lower than one would fear. “Checks and balances” built in.
The Salmon Cluster in Southern Chile

- Coordination between private and public actors helped promote high collective efficiency as well as upgrading in processes, product, and functions. Gradually became a global cluster with vertically integrated firms.

- Delayed regulations and excess investment damaged the environment and led to a production crisis in 2008.

- This case reveals **two important takeaways**:
  - **All policies and programs to promote clusters** – and the related institutions - **need to evolve over time** depending on the varying challenges and contexts prevailing in the sector.
  - In industries dependent on the long-term sustainability of natural resources the **close interaction between industry growth and the evolution of the associated institutions regulating the industry is essential**.
Beyond linkage strengthening……..

- However linkages strengthening is not all that matters
- on this see also GVC policies to enter and capture value within GVC, e.g. Pietrobelli C. and Staritz C., 2013, “Challenges for Global Value Chain Interventions in Latin America”, IADB, Technical Note No. IDB-TN-548, May, http://www.iadb.org/projectDocument.cfm?id=38815216

Experiential Knowledge, Networks and Institutions for SMEs
Experiential Knowledge, Networks and Institutions for SMEs

• SMEs in the region lack the material and knowledge resources to fill the large productivity gaps
• Lead firms have limited interest and capabilities to train more backward firms.
  – **SMEs especially need access to a variety of applied and experiential knowledge** that helps firms convert their capabilities from where they were to where they need to be.
  – **Certain constellations of public-private institutions can best facilitate this process.**
The dominant view on SME upgrading tends to propose solutions based on:

downstream buyers, such as MNCs, but

- a minimum level of capabilities and absorptive capacities of suppliers
- MNC subsidiaries may convey well to the local firms “what” they need to produce but not necessarily “how” or “why” (e.g. in automotive production implementation demands adaptation to the local context) or may not want it.
- Governance may go against it.
- Firm-level efforts often assumed implicitly.

innovation systems.
- Western advice argues for pioneering technology.
- In contrast, growing evidence on role of incremental changes.
- S&T institutions often have weak capacities.
- Rather need to recombine old habits and practices into new process capabilities that can meet needed performance standards
Beyond promoting linkages: The Role of Organizations for Knowledge Creation and Diffusion

- **Locally embedded public and private organization** may be better positioned than MNCs or global buyers for knowledge creation and diffusion.
- **Recombination** of a diversity of applied, experiential knowledge via the constellation of evolving non-market institutions such as schools, business associations, and government supported centers for training and extension.
- The public-private institutions vital for SME upgrading trigger both direct tutelage and social learning among the actors.
Case Studies in Developing Public-Private Institutions for Collective Learning

- Two case studies: (1) **Fresh produce suppliers in Chile** and (2) **Dairy farmers in Nicaragua**
- Local producers had severe difficulties implementing standards specified by MNCs. With the help of foreign agencies and governments, local producers:
  - Established key product and process standards and a system of local monitoring.
  - Established common organizational resources, from cooperatives to training centers, to help firms understand directly the how and why of the standards, and how to improve gradually their own practices.
- The organizations became necessarily embedded into the industry or region so they can draw on, integrate and diffuse to experiential and applied knowledge gathered from the firms themselves.
Conclusions

• SME participation in international markets and integration into value chains has great potential for technological and learning spillovers to SMEs.

• LAC policies must go beyond current practices.

• LAC policies need to aim at strengthening linkages as well as fostering SMEs’ access to diverse experiential and applied knowledge.

• Non-market institutions can be most effective in providing the relevant knowledge and training when they are structured to act as social and knowledge bridges across previously isolated producer communities.