





# Going Global

**Promoting the Internationalization  
of Small and Midsize Enterprises  
in Latin America and the Caribbean**



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# Table of Contents

Acknowledgements/ **v**

Executive Summary/ **vii**

Resumen/ **xvii**

Resumo/ **xxix**

## **Section I: Trends and Impacts of LAC SME Internationalization/ 1**

Introduction/ **3**

1. How Internationalized Are LAC SMEs?/ **9**
2. Impacts of Internationalization/ **57**

## **Section II: Obstacles to LAC SME Internationalization:**

**The Context for Action/ 87**

3. External Costs and Constraints/ **93**
4. Intra-Firm Determinants of Export Success/ **153**
5. Credit Constraints/ **199**
6. Innovations in Support Mechanisms for SME Internationalization/ **223**

## **Section III: High-Potential Strategies for Accelerating Internationalization among LAC SMEs/ 239**

7. Accelerating LAC SME Quality Participation in Global Value Chains/ **243**
8. Leveraging the US Hispanic Diaspora to Drive LAC SME Exports/ **263**
9. The Online Opportunity: Helping LAC SMEs Leverage Cross-Border E-Commerce/ **287**
10. Conclusion/ **301**



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# Executive Summary

## Introduction

Nations around the world have identified exports as a key for economic growth. This is clearly the case in Latin America and the Caribbean, where trade has become the lifeblood for practically all of the region's economies following two decades of structural reforms, extensive trade liberalization, and the formation of free trade agreements with leading economies.

The region's trade expansion has mainly been driven by large companies: multinationals and large, highly internationalized Latin American companies (multilatinas), which often make the bulk of their sales overseas. However, small and medium-sized enterprises (SMEs) are notably under-represented in the region's external sector despite their importance as the backbone of LAC economies and a source of employment for millions of people. SMEs constitute more than 95 percent of the region's companies, but only 13 percent of these firms engage in exports. In addition, LAC SMEs that do export tend to sell only a few products to a very small number of markets. These patterns not only stifle the potential for growth among LAC SMEs that could be attainable through gains from trade; they also render SMEs more vulnerable to domestic business cycles.

Countries in Latin America and the Caribbean stand to score significant growth gains by fostering SME internationalization, particularly by focusing on SMEs with a strong potential to succeed in international markets. SMEs that succeed in export markets will enable LAC countries to significantly expand and diversify their exports. Recent research around the world also shows that internationalization enables SMEs to become more productive, innovative, and competitive, thus offering an opportunity for LAC firms to grow into large companies that generate employment for thousands of people. Yet many LAC economies lag behind comparable emerging markets in SME export participation, diversification, and export sales.

The question is how to best support and accelerate SME internationalization in Latin America and the Caribbean. This report seeks to provide answers. We look at each of three key sides of the issue: the state of SME internationalization in Latin America and the Caribbean; the opportunities

and constraints for the regional SMEs to internationalize; and practical recommendations for policymakers, companies, and practitioners to accelerate SME internationalization. In particular, the report aims to answer several critical questions:

- Why does SME internationalization matter for LAC economies? What is the impact and importance of SME internationalization to LAC's growth and development?
- What is the state of SME internationalization in LAC? How internationalized are LAC SMEs today?
- What are the main constraints to SME internationalization in the region—both the external policy and economic barriers as well as SMEs' internal management and operational capabilities?
- What global best practices and policies can best further SME internationalization in LAC? What policies and programs to accelerate SME internationalization have been tested and tried in such regions as Asia, Europe, and North America—and how can these innovations be applied to LAC SMEs?
- What are the key policy and programmatic priorities for LAC governments and other stakeholders to advance SME internationalization in the region?

Through analyzing these key questions, this report seeks to spur cutting-edge thinking among LAC policymakers and business leaders on structuring support, programs, and initiatives to catalyze and expand SME internationalization in LAC. While grounded in rigorous academic literature and fresh analytics, the report is presented in a nontechnical fashion. We do this to make the report's insights and recommendations readily accessible and actionable among the many relevant regional stakeholders.

Our findings strongly suggest that successful and sustainable SME internationalization requires a paradigm shift. LAC must turn away from a granular focus on isolated support mechanisms that may or may not place SME priorities at the forefront, and embrace a holistic and coordinated set of national economic and trade policies along with requisite managerial and operational practices within SMEs and targeted institutional innovations. The following discussion lays out the report's findings and recommendations in greater detail.

## Why Does Internationalization Matter?

A rapidly growing body of empirical evidence on the benefits of SME internationalization includes the following:

- Internationalized SMEs outperform firms that do not engage in international trade. This holds true in LAC, where the region's SME exporters and importers alike employ more workers, pay higher wages, and achieve higher sales and labor productivity than comparable firms that do not engage in international trade. This relationship is twofold: better-performing companies self-select to international markets; and internationalization markedly fuels firm performance. Exporting increases firm productivity, boosts the sophistication of business capabilities, and loosens credit constraints, all of which are key factors for enabling SMEs to grow into large firms that drive trade and job creation.
- LAC SME exporters are critical for their countries' exports, both along the extensive and intensive export margins and in the growth of aggregate trade and the number of export products and markets. SME entrants that survive and export on a sustained basis can contribute very significantly to their countries' export growth. These firms are also critical for introducing new products to their countries' export baskets, and thus play a critical role in export diversification.
- SME internationalization provides important economic benefits for LAC economies that go beyond trade. Exporters tend to raise all boats in their home markets. By becoming more productive through exporting, exporters also reap a larger market share in their domestic markets, thus increasing the productivity of the entire economy. SME exporters can generate positive spillovers, such as growth and job creation in the many firms they rely on for inputs, products, and services. In addition, SME exporters are widely found to help create export ecosystems in their home countries by transferring valuable knowledge and skills gained through exporting to non-exporters and attracting "followers," i.e., companies that begin exporting in the same product categories with less risk after observing the first-mover SME's export success.

These gains notwithstanding, LAC SMEs have yet to fully embrace internationalization as a growth lever, let alone succeed at internationalization on a sustained basis. Consider three key findings in Chapter 1 of the report:

- **Fewer than 15 percent of LAC SMEs export.** Overall, LAC SMEs trail the export participation of SMEs in comparable economies. Smaller LAC SMEs participate much less in exporting than do larger SMEs, and these small firms tend to export less than similarly sized firms in other economies. LAC SMEs are, in short, relatively non-internationalized, and thus largely forego the growth gains from exporting.
- **Most LAC SME exporters are undiversified.** The typical LAC SME exporter exports just two products to only one market, and about a third of these firms are single-product and single-market exporters. To be sure, the region's exporters have over time become on average smaller and younger, which helps to explain the relatively limited diversification. Nonetheless, undiversified firms have little cushion: they cannot compensate for negative shocks and competitive pressures in one market by making sales to another.
- **LAC SMEs struggle with export survival.** About one-half of all LAC firms that set out to export exit the export market within a year, and most new product launches and market entries also fail. Compared to East Asia and advanced economies, LAC has low SME export survival rates, with more ad hoc, hit-and-run exporters than firms that export on a sustained basis. While a great many firms enter exporting, a great many also exit.

### Constraints to LAC SME Internationalization

These patterns suggest that LAC SMEs fail to perform on all three critical legs of the internationalization stool: export entry, export survival, and export diversification. The next question is why. This volume singles out three types of critical constraints and underlying market failures that particularly impede LAC SMEs seeking to enter and thrive in the global marketplace on a sustained basis.

The first set of bottlenecks is external. The costs and constraints of factors exogenous to the firm are discussed in Chapter 3. One such cost is sunk entry costs, or the up-front costs required for a firm to first enter a particular export arena that tend to disproportionately affect SMEs. The investment

level varies according to factors such as destination market and positive learning among firms within various sectors, and their analysis provides insights on managing this critical barrier.

LAC SMEs also face high trade costs that stem from inadequate transportation infrastructure, long customs clearance times, and high freight costs. Such trade costs are particularly burdensome to SMEs because they make export initiatives uneconomical at a low scale. Moreover, SMEs tend to lack sufficient agility to pursue investments that will ultimately raise profits per unit.

In addition, LAC SMEs struggle with the costs of trade compliance. These barriers are increasingly critical in light of the proliferation of both international standards and regional trade agreements, each with its unique set of rules of origin and other market access criteria. LAC SMEs have limited time and resources to understand complex public and private standards that differ from market to market. They are even less able to invest in complying with these standards, which range from certification to traceability to basic changes in production processes.

LAC SMEs also face serious informational asymmetries and gaps when serving global markets. Information constraints are a two-way street. On the one hand, SME exporters are challenged in acquiring and internalizing core information on market demand, partner reliability, buyer needs, logistics alternatives, de-facto product standards, and other key factors. On the other hand, overseas buyers may lack information on the LAC exporter's reputation and the quality and characteristics of its products, thereby forcing them to rely on their perception of the exporters' country.

The second set of constraints to LAC SME internationalization is internal to the firm.

Chapter 4 examines those intra-firm success drivers common to SME exporters and sheds new light on why only a portion of more efficient SMEs enter and succeed in exporting, how less efficient SMEs can improve their productivity relative to global markets, and what can be done to improve the success ratio. This analysis emphasizes the importance of key assets, such as management with an international background and a suite of hard-to-build capabilities, including specific methodologies to plan for risk and uncertainty, drive high-trust high-touch relationships with key channels and buyers, and create adaptive process and product innovations by improving on existing technologies and codifiable knowledge.

Already possessing a number of these capabilities are the “born-global” firms—high-value-added start-ups, often based in small domestic

economies, which internationalize with remarkable alacrity and success virtually out of the gate. The assets and capabilities discussed in this chapter appear to consistently distinguish successful SME exporters from their less thriving peers. LAC SMEs tend to lack these assets and capabilities. In this chapter we show that the more an SME has fully developed each of these drivers, and is able to invest in their further improvement, the greater its odds of export success.

The third challenge facing internationalizing LAC SMEs addressed in Chapter 5 is access to finance, the critical fuel for SME growth and internationalization that is also often sorely lacking. SMEs with stronger internal cash flows and access to bank credit export earlier than their credit-constrained peers, export a wider variety of goods, and expand to new export markets. In turn, successful exporting boosts SMEs' access to capital.

In LAC, the financing cup is perhaps half full, half empty. Compared to their peers in other developing regions, LAC SMEs tend to have a greater access to bank financing, and the regional banks are increasingly willing to lend to SMEs. However, bank finance has steep costs in the region: LAC SMEs face among the world's highest collateral requirements and net interest margins, and these firms also pay significantly higher interest rates than do their larger counterparts. In addition, alternative financing sources such as equity, supplier credit, and supply chain finance, require further development in LAC so as to benefit a far larger pool of the region's SMEs.

### **How to Make a Difference**

LAC SMEs face several constraints to internationalization, yet many companies still seem to beat the challenging odds. Public policy can play a leading role by reducing the market failures that constrain LAC SMEs' internationalization, and thus expand the number of SMEs that export and the overall SME exports.

This volume argues that policy attention needs to focus on three aspects: encouraging more widespread entry; supporting firms' export survival; and furthering firms' export diversification, which is one of the keys to export survival. Policy must mitigate the costs, risks, and other chokeholds, and increase the gains from export entry and sustained exporting. It is critical that policy interventions not focus on all SMEs, but rather on those that have the greatest chance of entering and growing in the global marketplace. And the focus must be integrated. There are no silver bullets for succeeding

at SME internationalization; rather, holistic solutions are required, from SME export capacity building designed with a deep understanding of export success drivers, to lowered transport costs and improved access to finance. Each chapter on the constraints to internationalization concludes with a detailed set of policy recommendations.

There are many ways to structure and sequence interventions. International experiences and best practices can guide Latin American and Caribbean policymakers and other stakeholders. This volume discusses several innovative international support mechanisms in export promotion and export finance that can be applied in LAC. Such interventions include the following:

- **Shared knowledge and experience.** By now, there is ample empirical evidence that exporters can inspire and concretely help other firms to export by transmitting knowledge about the export process and markets. Yet such externalities do not happen on their own. Policy interventions are needed to make them systematic, scalable, and impactful. Some examples might include virtual sectoral clusters and “mobility initiatives” to internationalize the workforce. The public sector not only provides the venue for such knowledge transfers; it also can play an important role in mitigating free-riding by non-exporters by offering incentives for the exporters to share their knowledge.
- **Pooled regional knowledge.** There are enormous opportunities to pool national and regional resources to build highly accessible and user-friendly information portals to guide SME exporters and export aspirants. Particularly useful would be a one-stop-shop information portal that brings together the many standards and rules involved in trade, foreign export markets, and export finance. Such a portal, designed with a business-friendly format, would be forcefully marketed to LAC SMEs. The IDB’s ConnectAmericas is an important step in this direction.
- **Scaled, customized capacity building.** Each exporter faces different circumstances. As such, “one-size-fits-all” advice has limited usefulness. And while tailor-made case management can work, particularly when delivered across the full chain of support, it is notoriously difficult to scale. Even more, the specific capabilities at the heart of successful SME internationalization are inherently learning-based, incremental, and require continual improvement. All this points to a

new opportunity to move beyond one-time training. This approach would leverage technology and provide SME managers with access to a full range of essential assessments, decision-making tools, and learning activities, empowering them to engage in continuous learning throughout the export trajectory.

- **Coordinated government and stakeholder action.** All too often resources and efforts to help SMEs internationalize are spread thin across several government agencies and stakeholder groups. SME internationalization requires holistic and integrated solutions to be successful, and this should be reflected in the design, organization, and implementation of support. For example, there should be tight coordination among the many agencies that solve different facets of the challenges facing globalizing SMEs, including export promotion, innovation policy, and economic development, to name a few. Similarly, there are opportunities to build synergies among the various entities that provide credit enhancements to SMEs, such as export credit and SME finance and development agencies.

Chapters 7–9 of this report identify immediately actionable strategies that are especially suitable for LAC region as a means to catalyze SME internationalization and help maximize results from limited support resources. These strategies rely on the region’s comparative advantages, and include the following three areas:

- **Accelerating LAC SMEs’ quality participation in global value chains (GVCs).** With a substantial presence of multinational firms in their region, LAC SMEs have an opportunity to supply global value chains, one of the best first steps for companies to internationalize. SMEs can benefit from their association with global companies, which are exacting in their requirements and put pressure on suppliers to improve quality, drive down costs, specialize, and constantly adapt and innovate. SME suppliers can also benefit from the information flows, technology transfer, and learning opportunities with the multinational and/or its lead supplier. In addition, supplying a large customer can enable an SME to produce larger volumes and harness scale economies. LAC SMEs presently face challenges in shouldering new risks and investments, and they must often struggle to become suppliers. And once they do become suppliers, they may not reap the benefits.



There are a number of policy interventions to expand the quality participation in GVCs, such as systems training and logistics technology centers that help SMEs to meet rigorous quality standards; initiatives to promote collective action to expand access and upgrade capabilities; and support to reduce what can be enormous strains on SME cash flow through supply chain financing.

- **Leveraging the US Hispanic Diaspora to drive LAC SME exports.** LAC SMEs are exceptionally well placed to win more business in one of the largest and fastest-growing markets worldwide—the US Hispanic market. With both consumer and business segments booming, this market boasts unique advantages for exports from the region. It shares an overriding commitment to the Spanish language as well as to cultural relevancy. It also calls for distinctive purchasing, technology, and media patterns that allow for targeted marketing. The US Hispanic Diaspora market is Latin America's to win: SMEs from any other world region would be hard-pressed to serve this market on a large scale. LAC economies can do much more to help SMEs engage with this giant market, such as forming influential relationships within the Diaspora to accelerate LAC SME internationalization, developing an in-depth repository of information, and helping LAC SME exporters pursue financing options for US market penetration.
- **Helping SMEs to leverage cross-border e-commerce.** One of the most powerful ways for LAC SMEs to reach global markets is through e-commerce. Selling online reduces the physical, informational, and cultural distances that limit trade across borders. The regional supply side has promise: compared with much of the developing world, Latin American SMEs are rather well-connected to the web. And demand is growing right under LAC SMEs' noses: the intra-regional online market is expanding extremely fast. Yet LAC SMEs have yet to fully tap this online export opportunity. The region's companies need to be made aware of the benefits of using the Internet in promoting their business, and to take advantage of the Internet's full potential for internationalization. These benefits include identifying foreign markets and customers, marketing products and services to overseas customers, and using online payments. The region should also ensure that LAC SMEs have a level playing field in cyberspace, rein in taxes and fees on online purchases, and ensure that packages are fully trackable in postal systems.

To be sure, this volume is not the last word on SME internationalization in the LAC region. There is much room for further empirical research on the bottlenecks specific to LAC SME internationalization, and for developing additional actionable solutions and practical tools that can fully unleash the growth opportunity of SME internationalization. However, it is our hope that this volume will demonstrate the enormous opportunity represented by LAC SME internationalization for the region's economies and citizens, and to inspire fresh thinking and coordination on the best ways to seize that opportunity—starting today. Much has already been accomplished in the region. At a time of stiffening global competition for export market share and for foreign direct investment, these efforts will now have to be stepped up. The payoff will be well worth the effort.

# Resumen

## Introducción

Las exportaciones han sido identificadas por todos los países del mundo como una de las claves del crecimiento económico. Lo mismo sucede en América Latina y el Caribe (ALC), donde el comercio internacional se ha convertido en la fuerza motriz de casi todas las economías después de dos décadas de reformas estructurales, apertura comercial y firma de numerosos tratados de libre comercio.

La expansión comercial de la región ha sido impulsada principalmente por grandes empresas: multinacionales y grandes firmas latinoamericanas altamente internacionalizadas (multilatinas) que por lo general efectúan la mayoría de sus ventas en el exterior. En cambio, las empresas pequeñas y medianas (PyME) se encuentran notablemente subrepresentadas en su sector externo, a pesar de que constituyen la columna vertebral de las economías de ALC y una fuente de empleo para millones de personas. Las PyME representan más del 95% de las empresas de la región, aunque solo el 13% de ellas exporta, y las que lo hacen venden solo unos pocos productos en una cantidad muy reducida de mercados. Ello no solo limita el potencial de crecimiento que podrían realizar a través de las ganancias asociadas al comercio, sino que además las hace vulnerables a los ciclos económicos domésticos.

Los países de ALC pueden lograr avances significativos si fomentan la internacionalización de las PyME, en particular si se enfocan en aquellas que tengan posibilidades de triunfar en los mercados internacionales. Las PyME que logren tener éxito en los mercados de exportación harán que los países de ALC expandan y diversifiquen significativamente sus exportaciones. En varias investigaciones conducidas en distintas partes del mundo también se señala que la internacionalización hace que las PyME se tornen más productivas, innovadoras y competitivas, con lo cual tienen la oportunidad de convertirse en compañías grandes que generen empleo para miles de personas. Sin embargo, en comparación con otros mercados emergentes, muchas economías de ALC se encuentran rezagadas en cuanto al volumen de exportaciones, diversificación y ventas externas de sus PyME.

La cuestión es cómo apoyar y acelerar la internacionalización de las PyME en ALC. En este informe se busca responder a esta pregunta a

través de un análisis del estado de la internacionalización de las PyME en ALC, y de las oportunidades y restricciones que existen para que estas se internacionalicen y la identificación de una serie de recomendaciones prácticas dirigidas a los responsables por la formulación de políticas, a las empresas mismas y a los profesionales del campo tendientes a acelerar dicha internacionalización. En concreto, en este informe se intenta responder a las siguientes preguntas críticas:

- ¿Por qué es importante la internacionalización para las economías de ALC? ¿Qué impacto tiene la internacionalización en su crecimiento y desarrollo?
- ¿Cuál es el estado de la internacionalización de las PyME en la región? ¿En qué medida se encuentran internacionalizadas las PyME de ALC hoy en día?
- ¿Cuáles son las principales limitaciones para la internacionalización de las PyME en la región, tanto desde el punto de vista de las políticas y de las barreras económicas externas, como de su gestión y de sus capacidades operativas internas?
- ¿Qué tipo de políticas y programas han sido ensayados en regiones como Asia, Europa y América del Norte? ¿Qué buenas prácticas y políticas globales podrían impulsar mejor la internacionalización de las PyME en ALC? ¿Cómo se pueden aplicar estas innovaciones a las PyME de ALC?
- ¿Cuáles son las políticas claves y prioridades programáticas de los gobiernos de ALC y otros actores para avanzar en la internacionalización de las PyME en la región?

Al abordar estas preguntas fundamentales, con este informe se espera promover ideas innovadoras entre los responsables de la formulación de políticas y dirigentes empresariales acerca de cómo estructurar el apoyo, los programas e iniciativas dirigidas a catalizar y expandir la internacionalización de las PyME en la región. Aunque este informe se basa en una rigurosa literatura académica y en análisis recientes, sus hallazgos se presentan de una manera no técnica, ya que el objetivo que se persigue es que las ideas y recomendaciones aquí ofrecidas estén al alcance de todos aquellos actores relevantes de la región que las puedan llevar a la práctica.

Nuestros hallazgos sugieren claramente que una internacionalización exitosa y sostenible de las PyME exige un cambio de paradigma. ALC

debe alejarse de una estrategia basada en mecanismos de apoyo aislados que pueden o no favorecer las prioridades de las PyME, para adoptar en su lugar un conjunto de políticas económicas y comerciales integradas y coordinadas, una serie de prácticas básicas de gestión y operativas dentro de las PyME e innovaciones institucionales puntuales. En las siguientes páginas se presentan de manera pormenorizada los hallazgos de este informe y las recomendaciones correspondientes.

### ¿Por qué es importante la internacionalización?

Existe cada vez más evidencia empírica sobre los beneficios que conlleva la internacionalización de las PyME:

- Las PyME internacionalizadas se desempeñan mejor que otras firmas que no participan en el comercio internacional. Esto también sucede en ALC, donde tanto las PyME exportadoras como las importadoras emplean una mayor cantidad de trabajadores, pagan mejores salarios y tienen un mayor volumen de ventas y una productividad laboral más alta que otras empresas comparables que no están vinculadas a esta actividad. Esta relación es bidireccional: las compañías de mejor desempeño se autoseleccionan para participar en los mercados internacionales, mientras que la internacionalización alimenta notablemente el desempeño de estas empresas. La participación en los mercados de exportación redundo en aumentos de productividad, mayor sofisticación de sus capacidades empresariales y menores restricciones crediticias, aspectos todos críticos para posibilitar que las PyME se conviertan en empresas más grandes con la capacidad de impulsar el comercio y la creación de puestos de trabajo.
- Las PyME exportadoras de ALC son críticas para las exportaciones de sus respectivos países, tanto en el margen extensivo como en el margen intensivo, así como en el crecimiento agregado del comercio y en la cantidad de productos y mercados de exportación. Las PyME entrantes que logran sobrevivir y que exportan de manera sostenida pueden contribuir de manera muy significativa al crecimiento exportador de sus países. Estas empresas también desempeñan un papel crítico en lo que se refiere a la introducción de nuevos productos a las canastas exportadoras de sus países, y por ende en la diversificación exportadora.

Los beneficios de la internacionalización de las PyME para las economías de ALC van más allá del comercio. En la medida en que se tornan más productivas gracias a sus ventas externas, las firmas exportadoras logran una mayor participación en sus mercados domésticos y por esa vía aumentan la productividad de toda la economía. Las PyME exportadoras también pueden generar efectos de derrame, como por ejemplo crecimiento y generación de empleo en todas aquellas firmas a las cuales recurren para obtener insumos, productos y servicios. Además, se ha determinado reiteradamente que estas PyME ayudan a crear ecosistemas exportadores en sus países de origen, en virtud de que transfieren los valiosos conocimientos y destrezas adquiridos exportando a otras firmas que no lo hacen. Así, por ejemplo, atraen “seguidoras”, es decir, compañías que comienzan a exportar en las mismas categorías de productos pero con menor riesgo después de haber observado el éxito exportador de la primera que hizo el intento.

A pesar de tales ganancias, las PyME de ALC distan de haber aprovechado plenamente la internacionalización como palanca de crecimiento y/o de lograr un éxito exportador sostenible, como lo demuestran tres de los principales hallazgos del capítulo 1 de este informe:

- **Menos del 15% de las PyME de ALC exporta.** En general, su participación en las exportaciones se encuentra rezagada frente a la de otras economías comparables. Las PyME más pequeñas participan mucho menos que las de mayor tamaño; lo mismo en comparación con PyME de su mismo tamaño en otras economías. En pocas palabras, las PyME de ALC se encuentran poco internacionalizadas en términos relativos, y por lo tanto, no explotan apropiadamente las ganancias de crecimiento derivadas de tal actividad.
- **La mayoría de las PyME exportadoras de ALC no están diversificadas.** La típica PyME de ALC vende solo dos productos a un solo mercado, y cerca de una tercera parte exporta un solo bien a un único mercado. Si bien a lo largo del tiempo las PyME exportadoras de la región se han vuelto más pequeñas y más jóvenes en promedio —lo cual ayuda a explicar de alguna manera su grado de diversificación relativamente limitado—, ello no modifica el hecho de que las firmas poco diversificadas no tienen cómo protegerse, pues no están en capacidad de compensar los shocks negativos y las presiones competitivas efectuando ventas a otra empresa.

- **A las PyME de ALC se les dificulta sobrevivir en la actividad exportadora.** Cerca de la mitad de las empresas de ALC que comienzan a exportar abandona el mercado exportador en el curso de un año; la mayoría de lanzamientos de productos y entradas al mercado también fracasan. En comparación con el Asia del Este y economías avanzadas, las de ALC tienen tasas muy bajas de supervivencia exportadora. Si bien son numerosas las firmas que entran a esta actividad, también son muchas las que la abandonan. Existen más exportadores de oportunidad que entran y salen que empresas con ventas externas sostenibles.

### Restricciones a la internacionalización de las PyME

Los patrones arriba mencionados sugieren que las PyME de ALC no logran un buen desempeño en las tres áreas críticas de la internacionalización por la vía exportadora: entrada, supervivencia y diversificación. La pregunta es por qué. En este volumen se destacan tres tipos de limitaciones críticas y las fallas de mercado subyacentes que impiden particularmente a las PyME entrar y prosperar de manera sostenible en los mercados mundiales.

El primer conjunto de cuellos de botella es externo. Los costos y las limitaciones asociados a factores exógenos a la empresa se discuten en el capítulo 3. Uno de ellos es el de los costos directos en los que incurre una firma para entrar por primera vez en algún campo exportador, lo cual tiende a afectar de manera desproporcionada a las PyME. Los niveles de inversión varían según factores como el mercado de destino y los efectos de aprendizaje entre empresas dentro de varios sectores. En este capítulo se proporcionan algunas ideas sobre cómo manejar esta barrera crítica.

Las PyME de ALC también incurren en altos costos de comercio derivados de la carencia de infraestructura adecuada de transporte, las prolongadas demoras ocasionadas por los controles aduaneros, y los altos costos del transporte. Todo ello impone un peso significativo a las PyME, pues hacen que las iniciativas exportadoras de tamaño reducido resulten poco económicas. Más aún, las PyME tienden a carecer de la agilidad suficiente para realizar inversiones que en última instancia aumentan la rentabilidad por unidad.

Además, las PyME de ALC también deben lidiar con los costos que conlleva el cumplimiento de los requisitos del comercio internacional. Estas barreras son cada vez más críticas a la luz de la proliferación de normas técnicas o estándares internacionales y de los tratados de libre comercio, cada

uno de los cuales tiene sus propias reglas de origen y sus propios criterios de acceso a los mercados. Las PyME de ALC carecen de los recursos y el tiempo necesarios para entender plenamente estos estándares —públicos o privados—, que además difieren de un mercado a otro. Su capacidad es aún menor cuando se trata de invertir en el cumplimiento de tales estándares, que van desde la certificación de productos hasta su trazabilidad, pasando por cambios básicos en los procesos de producción.

Las PyME de ALC confrontan a su vez serias asimetrías de información y otras brechas cuando buscan atender los mercados mundiales. Las limitaciones de información son de doble vía. Por un lado, las PyME exportadoras afrontan el desafío de adquirir e internalizar información relevante sobre la demanda del mercado, confiabilidad del socio, necesidades del comprador, alternativas de logística, estándares de hecho para sus productos y otros factores claves. Por otra parte, los compradores externos también pueden carecer de información sobre la reputación de los exportadores de ALC, así como sobre la calidad y características de sus productos. Esto los obliga a recurrir a sus propias percepciones sobre el país de los exportadores.

El segundo conjunto de limitaciones para la internacionalización de las PyME de ALC es interno a la propia firma. En el capítulo 4 se examinan aquellos factores de éxito propios de la empresa que caracterizan a las PyME exportadoras y que ayudan a aclarar por qué solo una porción de las más eficientes exhiben éxito exportador; de qué manera las PyME menos eficientes pueden mejorar su productividad vis à vis los mercados mundiales; y qué se puede hacer para mejorar la tasa de éxito. En este análisis se hace énfasis en la importancia de activos claves como una gestión basada en la experiencia internacional y un conjunto de capacidades difíciles de desarrollar; esto último incluye metodologías específicas de planificación de riesgo y manejo de incertidumbre, relaciones de cercanía y confianza con canales y compradores claves, un proceso adaptativo e innovaciones de productos a través de la mejora de tecnologías existentes y conocimientos codificables.

Existen nuevos emprendimientos de alto valor agregado que “nacen globales” y ya poseen varias de estas capacidades. Estos por lo general se encuentran en economías pequeñas y se internacionalizan con marcada celeridad y éxito desde que arrancan. Los activos y capacidades que se discuten en este capítulo permiten distinguir de manera consistente entre los exportadores exitosos y aquellos con menores logros. Las PyME de ALC tienden a carecer de ellos. Aquí se muestra que cuanto más logren desarrollar



plenamente cada uno de estos elementos impulsores e invertir en su mejoramiento, mayores serán sus probabilidades de éxito.

El tercer desafío que confrontan las PyME de ALC que buscan internacionalizarse, abordado en el capítulo 5, es el acceso a financiamiento. Este es el combustible crítico para el crecimiento de las PyME y del cual por lo general carecen. Aquellas PyME que logran un buen flujo de caja interno y acceso a crédito exportador bancario antes que sus pares que sufren de tales limitaciones, venden una mayor variedad de productos en el exterior y se expanden hacia nuevos mercados externos. A su vez, el éxito exportador favorece el acceso a crédito de las PyME.

En ALC, la situación del financiamiento muestra que el vaso se encuentra medio lleno y medio vacío. Comparadas con sus pares en otros países en vías de desarrollo, las PyME de ALC tienden a tener un mayor acceso a crédito bancario, y los bancos regionales parecen estar cada vez más dispuestos a otorgarles préstamos. Sin embargo los costos son altos: las exigencias en materia de garantías bancarias y los márgenes de interés netos que enfrentan las PyME de la región se encuentran entre los más altos del mundo; además, estas empresas pagan tasas de interés significativamente más elevadas que las de sus pares de mayor tamaño. Asimismo, en ALC todavía falta desarrollar plenamente fuentes alternativas de financiamiento, entre ellas el mercado accionario, crédito para proveedores y/o financiamiento de cadenas de valor, con el fin de que puedan beneficiar a un grupo mucho más amplio de PyME.

### Cómo marcar la diferencia

Aunque las PyME de ALC se enfrentan a varios retos en materia de internacionalización, son muchas las que logran salir adelante contra todos los pronósticos. La política pública puede desempeñar un papel fundamental reduciendo las fallas de mercado que limitan su internacionalización, con lo cual aumentaría la cantidad de PyME que exportan, así como su volumen global de exportaciones.

En esta publicación se arguye que la política debe enfocarse en tres aspectos: fomentar ampliamente la entrada de las PyME al negocio exportador; prestarles apoyo para favorecer su supervivencia; y promover la diversificación exportadora de estas empresas, lo que a su vez constituye una de las claves de su supervivencia. La política debe dirigirse a mitigar los costos, riesgos y otras posibilidades de estrangulamiento, y a aumentar las

ganancias derivadas de la entrada al negocio exportador y el desarrollo sostenido del mismo. Es esencial que las intervenciones de política no se centren en todas las PyME per se sino en aquellas que tienen mayores probabilidades de entrar al mercado global y expandirse en el mismo. El enfoque debe ser integrado. No existen fórmulas mágicas que garanticen que la internacionalización tendrá éxito; por eso se requieren soluciones holísticas de amplio alcance: desde desarrollar capacidades en las PyME a partir de un profundo conocimiento de los factores que impulsan el éxito exportador, hasta reducir los costos de transporte, pasando por ampliar el acceso a financiamiento. Cada uno de los capítulos sobre las limitaciones a la internacionalización concluye con un conjunto detallado de recomendaciones de política.

Existen varias maneras de estructurar y secuenciar las intervenciones. Tanto la experiencia como las mejores prácticas internacionales pueden servir de guía a los responsables de formular las políticas y a otros actores en América Latina y el Caribe. En este volumen se discuten varios mecanismos internacionales de apoyo innovadores en materia de promoción de exportaciones y financiamiento del comercio exterior que se pueden aplicar en ALC. Entre tales intervenciones figuran:

- **Experiencias y conocimientos compartidos.** Existe evidencia suficiente sobre el hecho de que los exportadores pueden inspirar y ayudar concretamente a otras empresas a exportar mediante la transmisión de conocimientos sobre el proceso de exportación y sobre los mercados. Sin embargo, tales externalidades no surgen de la nada. Se necesitan intervenciones de política que las conviertan en algo sistemático, escalable y con impactos. Entre los ejemplos figuran las aglomeraciones empresariales o clústeres sectoriales y las “iniciativas de movilidad” dirigidas a internacionalizar la fuerza laboral. El sector público no solo puede proporcionar los canales disponibles para que se produzcan tales transferencias de conocimientos, sino que además puede desempeñar un papel muy importante en cuanto a evitar comportamientos oportunistas; esto se lograría dando incentivos específicos a aquellos exportadores que estén dispuestos a compartir sus conocimientos.
- **Acervo de conocimiento regional.** Existen enormes oportunidades para reunir y acumular recursos nacionales y regionales destinados a poner en marcha portales informativos ampliamente accesibles y de fácil uso para guiar a las PyME que ya exportan y a las que aspiran a hacerlo. Sería de gran utilidad contar con un portal centralizado donde

se encuentre toda la información necesaria acerca de estándares y reglas sobre comercio internacional, mercados externos de exportación y financiamiento de la actividad exportadora. La promoción intensa de un portal de esta naturaleza, diseñado en un formato sencillo, sería de mucha utilidad para las PyME de ALC. La iniciativa *ConnectAmericas* del BID es un paso importante en esta dirección.

- **Desarrollo de capacidades a la medida y a escala.** Cada exportador se encuentra en circunstancias distintas. Es por ello que las soluciones tipo “talla única” tienen una utilidad limitada. Y si bien el manejo caso por caso puede funcionar, particularmente si se ofrece a lo largo de toda la cadena de apoyo, es sumamente difícil de escalar. Más aún, las capacidades específicas que se encuentran en el núcleo mismo de una internacionalización exitosa se basan en el aprendizaje, son inherentemente incrementales y exigen un mejoramiento continuo. Todo apunta a la necesidad de promover modelos de capacitación sostenible en el mediano plazo. El nuevo enfoque debería apalancar tecnología y dotar a los gerentes de las PyME de acceso a un rango amplio de diagnósticos esenciales, herramientas de toma de decisiones y actividades de aprendizaje que les permita involucrarse en un proceso de aprendizaje continuo a lo largo de la trayectoria exportadora.
- **Coordinación de las acciones gubernamentales y de actores interesados.** Es muy común que los esfuerzos dirigidos a ayudar a las PyME a internacionalizarse se dispersen en una serie de agencias gubernamentales y otros grupos interesados. Una internacionalización exitosa de las PyME exige soluciones holísticas e integradas, lo cual se debe reflejar a su vez en el diseño, organización e implementación de las medidas de apoyo. Por ejemplo, debe existir una estrecha coordinación entre las varias agencias encargadas de abordar las diferentes facetas de los desafíos que enfrentan las PyME que buscan globalizarse, entre ellas la promoción de exportaciones, las políticas de innovación y el desarrollo empresarial, para mencionar solo algunas. Del mismo modo, existen oportunidades para construir sinergias entre las distintas entidades que proporcionan herramientas financieras a las PyME, como por ejemplo aquellas que otorgan crédito para la exportación y las que prestan servicios financieros y de desarrollo para la pequeña y mediana empresa.

En los capítulos 7 a 9 de este informe se identifican estrategias ya listas para ser implementadas; estas son especialmente aptas para la región cuando se trata de catalizar la internacionalización y de ayudar a maximizar los resultados obtenidos con los pocos recursos de apoyo disponibles. Se basan en las ventajas comparativas de la región y con ellas se busca:

- **Acelerar la participación y mejorar el perfil de la inserción de las PyME de ALC en las cadenas de valor globales (CVG).** Dada la presencia significativa de firmas multinacionales en la región, las PyME de ALC tienen la oportunidad de convertirse en proveedoras de las CVG, uno de las primeras alternativas para empresas que buscan internacionalizarse. Las PyME de la región se pueden beneficiar de su asociación con compañías mundiales, dado que sus requisitos son bastante exigentes y además presionan a sus proveedores para que mejoren calidad, disminuyan costos, se especialicen, se adapten constantemente e innoven. Estas PyME proveedoras también pueden aprovechar los flujos de información, la transferencia de tecnologías y las oportunidades de aprendizaje que surgen con las multinacionales y/o con su principal proveedor. Además, el servir de proveedoras para clientes de gran tamaño permite que las PyME produzcan grandes volúmenes y aprovechen las economías de escala. Dado que actualmente las PyME deben afrontar un mayor peso derivado de nuevos riesgos e inversiones, por lo general tienen dificultades para convertirse en proveedoras. Y una vez que lo logran, no siempre cosechan beneficios. Existe una serie de intervenciones de política que pueden contribuir a ampliar y a mejorar la participación de las PyME en las CVG, a saber: centros de capacitación en sistemas y tecnología de logística que brinden asistencia a las PyME para que puedan cumplir estándares de calidad rigurosos; iniciativas dirigidas a promover la acción colectiva para fortalecer sus capacidades y expandir el acceso a los mercados externos; y apoyo para reducir las presiones sobre los flujos de caja de las PyME mediante financiamiento de la cadena de suministro.
- **Aprovechar la diáspora hispana para impulsar las exportaciones de las PyME de ALC.** Las PyME de ALC se encuentran excepcionalmente bien posicionadas para aumentar su volumen de negocios en uno de los mercados de más rápido crecimiento: el mercado hispano en Estados Unidos. Dado el auge de los segmentos de consumidores y de empresas, este mercado exhibe ventajas verdaderamente únicas

para las exportaciones originadas en la región, no solo porque comparte el compromiso fundamental con el idioma sino también con la pertinencia cultural. Los patrones específicos de compra, tecnología y medios de comunicación permiten realizar labores de mercadeo específicamente dirigidas a ese segmento. El mercado de la diáspora hispana en Estados Unidos está ahí para que América Latina lo aproveche, ya que a las PyME de cualquier otra parte del mundo les resultaría más difícil atenderlo en gran escala. Las economías de ALC podrían intensificar seriamente los esfuerzos dirigidos a apoyar a sus PyME para que participen en este mercado gigantesco a fin de acelerar su internacionalización, desarrollar un repositorio de información detallada y encontrar alternativas de financiamiento para penetrar este mercado en Estados Unidos.

- **Facilitar a las PyME el apalancamiento del comercio electrónico transfronterizo.** El comercio electrónico es una de las herramientas más poderosas para que las PyME de ALC lleguen a los mercados mundiales. Las ventas en línea reducen las distancias físicas, de información y culturales que limitan el comercio transfronterizo. El lado de la oferta regional es prometedor: comparadas con las de otras regiones en desarrollo del mundo, las PyME de ALC se encuentran bastante bien conectadas a internet. En cuanto a la demanda, está creciendo justo en sus propios territorios: el mercado intrarregional en línea se está expandiendo aceleradamente. Aun así, las PyME de ALC no han aprovechado plenamente esta oportunidad exportadora en línea. Las compañías de la región deben tomar conciencia de los beneficios que conlleva el uso de internet en la promoción de sus negocios y aprovechar al máximo el potencial de internacionalización que esta ofrece. Entre los beneficios que brinda figuran la identificación de mercados y clientes externos, el mercadeo de productos y servicios a los clientes del exterior, y el uso de mecanismos de pago electrónicos. La región también debería asegurarse de que sus PyME compitan en igualdad de condiciones en el ciberespacio, abstenerse de crear impuestos y otros cargos para las compras en línea y asegurarse de que los envíos sean plenamente rastreables en los sistemas de correo.

El presente volumen no aspira a constituirse en la última palabra en materia de internacionalización de las PyME de ALC. Queda todavía mucho por hacer en el campo de la investigación empírica sobre cuellos de botella

específicos, así como en lo que se refiere a formular soluciones operativas adicionales y herramientas prácticas que contribuyan a potenciar las oportunidades de crecimiento contenidas en la internacionalización de las PyME tanto para las economías como para los ciudadanos de la región. Sin embargo, esperamos que este volumen contribuya a poner de relieve dichas oportunidades, inspire ideas frescas y propicie esfuerzos de coordinación para aprovecharlas de la mejor manera posible desde este mismo momento. Los logros de la región han sido numerosos. En un momento en que la competencia global se intensifica para obtener mayor participación en el mercado exportador y en la inversión extranjera directa, será necesario redoblar estos esfuerzos para superar esos logros.

# Resumo

## Introdução

Em todo o mundo, as exportações têm sido identificadas pelos países como fator chave para o crescimento econômico. Esse é claramente o caso da América Latina e do Caribe (ALC), onde, após duas décadas de reformas estruturais, ampla liberalização comercial e de acordos de livre comércio com as principais economias, o comércio exterior se tornou um dos principais meios de sobrevivência para praticamente todas as economias da região.

A expansão do comércio exterior da região tem sido impulsionada por grandes empresas multinacionais e grandes firmas latino-americanas fortemente internacionalizadas (multilatinas), que muitas vezes fazem a maior parte de suas vendas para o exterior. As pequenas e médias empresas (PMEs), porém, estão claramente sub-representadas no setor de exportação da região, apesar de sua importância como espinha dorsal das economias da ALC e fonte de emprego para milhões de pessoas. As PMEs constituem mais de 95 % das empresas da região, mas apenas 13 % delas se dedicam à exportação e tendem a vender apenas poucos produtos a um número muito reduzido de mercados. Essa situação não apenas restringe o seu potencial de crescimento, mas também as torna mais vulneráveis aos ciclos econômicos em seus mercados internos.

Os países da ALC poderiam crescer mais rápido através do incentivo à internacionalização das PMEs, particularmente se esse incentivo se concentra nas firmas com maior possibilidade de êxito em mercados internacionais. As PMEs que obtiverem êxito nas exportações ajudarão os países latino-americanos a expandir e diversificar de modo significativo suas exportações. Pesquisas recentes em todo o mundo mostram também que a internacionalização permite que as PMEs se tornem mais produtivas, inovadoras e competitivas, oferecendo assim uma oportunidade às firmas da região para que cresçam e se tornem grandes empresas, capazes de gerar empregos para milhares de pessoas. Mas, na maioria das economias latino-americanas e caribenhas, a participação das PMEs nas exportações e o volume e diversificação de suas vendas no exterior estão abaixo da média dos mercados emergentes.

A internacionalização das PME é uma grande oportunidade de crescimento para a América Latina e o Caribe. A questão é saber qual a melhor

maneira de apoiar e acelerar essa internacionalização. Este estudo procura oferecer algumas respostas a isso. Examinamos cada uma das três facetas principais do problema: o estado da internacionalização das PMEs na ALC; as oportunidades e os obstáculos para que elas se internacionalizem; e recomendações práticas aos formuladores de políticas públicas, empresas e especialistas para acelerar a internacionalização das PMEs. O estudo visa, particularmente, responder a diversas perguntas fundamentais:

- Por que a internacionalização das PMEs é importante para as economias da ALC? Qual o impacto e a importância da internacionalização das PMEs para o crescimento e desenvolvimento da ALC?
- Qual a situação da internacionalização das PMEs na ALC? Qual o seu grau de internacionalização hoje?
- Quais os principais obstáculos à internacionalização das PMEs na região, tanto em relação à política externa e barreiras econômicas quanto à administração interna e capacidade operacional das PMEs?
- Quais são as melhores práticas e políticas para incentivar a internacionalização das PMEs na ALC? Que políticas e programas de aceleração da internacionalização das PMEs foram testados e postos em prática em regiões como a Ásia, Europa e América do Norte, e como essas inovações podem ser aplicadas às PMEs da ALC?
- Quais são as prioridades programáticas e de política pública fundamentais para que os governos da ALC e outras partes interessadas levem avante a internacionalização das PMEs da região?

Mediante o exame dessas perguntas chave, este estudo procura promover ideias inovadoras entre os formuladores de políticas públicas e líderes empresariais na ALC para estruturar apoio, programas e iniciativas destinados a catalisar e expandir a internacionalização das PMEs. Embora esteja embasado em literatura acadêmica rigorosa e análises recentes, o estudo não é apresentado em formato técnico, permitindo que suas conclusões e recomendações sejam de fácil acesso e possam ser postas em ação pelos vários atores relevantes na região.

Nossas conclusões indicam claramente que a internacionalização bem-sucedida e sustentável das PMEs requer uma mudança de paradigma. A região precisa rejeitar um enfoque fragmentado, com mecanismos de apoio isolados, que podem ou não priorizar as PMEs, e optar por um conjunto holístico e coordenado de políticas nacionais econômicas e comerciais,



juntamente com práticas operacionais e de gestão necessárias nas PMEs e inovações institucionais focalizadas. Os argumentos a seguir expõem as conclusões e recomendações do estudo em maiores detalhes.

### Por que a internacionalização é importante?

Um conjunto crescente de evidências empíricas sobre os benefícios da internacionalização das PMEs revela que:

- As PMEs internacionalizadas têm um desempenho superior ao de firmas que não estão engajadas em comércio internacional. Isso se aplica também à ALC, onde tanto as PMEs exportadoras como as importadoras empregam mais, pagam salários mais altos e têm um nível maior de vendas e produtividade do trabalho do que firmas comparáveis que não estão envolvidas em comércio internacional. Esse relacionamento se dá em dois níveis: empresas com melhor desempenho se autosselecionam para os mercados internacionais; e a internacionalização alimenta o desempenho das empresas. A exportação aumenta a produtividade da empresa, impulsiona a sofisticação da capacidade de negócios e relaxa as restrições de crédito, fatores cruciais para permitir que as PMEs cresçam e se tornem firmas maiores, que estimulam o comércio e a criação de empregos.
- As PMEs exportadoras da ALC são essenciais às exportações de seus países, não só para expandir o volume exportado, mas também para diversificar o número de produtos e mercados envolvidos. As PMEs iniciantes que sobrevivem e exportam em bases sustentáveis podem contribuir significativamente para o crescimento das exportações de seus países. Essas firmas são também essenciais para introduzir novos produtos na pauta de exportação de seus países, desempenhando assim um papel importante na sua diversificação.
- A internacionalização das PMEs traz para as economias da ALC benefícios econômicos importantes que vão além do comércio exterior. Os exportadores tendem a melhorar o desempenho de todas as firmas locais. Por serem mais produtivos graças à atividade exportadora, eles também captam uma fatia maior do mercado interno, aumentando assim a produtividade de toda a economia. As PMEs exportadoras podem gerar, nas firmas de que dependem para insumos, produtos e serviços, efeitos positivos como crescimento e mais

empregos. Além disso, tem-se constatado que cada vez mais as PMEs exportadoras, ao transferir conhecimentos e habilidades valiosos adquiridos no ramo aos não exportadores, ajudam a criar ecossistemas de exportação em seus países de origem, atraindo “seguidores”, ou seja, empresas que depois de observar o êxito de PMEs pioneiras na exportação começam a exportar nas mesmas categorias de produtos com menos risco.

Apesar desses benefícios, as PMEs da ALC ainda têm um longo caminho à frente para adotar inteiramente a internacionalização como alavanca de crescimento e alcançar resultados em uma base sustentável. Basta analisar três descobertas chave do Capítulo 1:

- **Menos de 15 % das PMEs da ALC exportam.** Em geral, as PMEs da ALC estão na retaguarda de economias comparáveis no que toca à participação das PMEs nas exportações. As PMEs de menor porte exportam proporcionalmente menos do que as PMEs de maior porte, e as PMEs da região tendem a exportar menos do que as firmas de porte semelhante em outras economias. Em resumo, as PMEs da ALC são relativamente menos internacionalizadas, deixando, portanto de auferir os ganhos de crescimento das exportações.
- **A maioria das PMEs exportadoras da ALC não é diversificada.** As exportações de uma PMEs típica na ALC consistem em apenas dois produtos dirigidos a um único mercado, e cerca de um terço dessas firmas exporta apenas um produto para um único mercado. É bom observar que, ao longo do tempo, os exportadores da região foram se tornando, em média, menores e mais jovens, o que ajuda a explicar a diversificação relativamente limitada. Mas as firmas não diversificadas, por não terem mercados alternativos, não conseguem compensar os choques negativos e as pressões competitivas em seu mercado de atuação.
- **As PMEs da ALC têm dificuldade para sobreviver no mercado internacional.** Cerca de metade das firmas da ALC que decidem exportar saem desse mercado em um ano, e a maioria dos lançamentos de novos produtos e ingressos no mercado também fracassam. Em comparação com o Leste da Ásia e as economias avançadas, a ALC apresenta baixa taxa de sobrevivência na área de exportação, com mais exportadores *ad hoc* e extemporâneos do que empresas que exportam

em base sustentável. Embora várias empresas ingressem no setor de exportação, por outro lado, outras tantas saem.

### **Obstáculos à internacionalização das PMEs na ALC**

Esse padrão sugere que as PMEs da ALC têm desempenho falho nas três áreas críticas que sustentam a internacionalização: ingresso no setor de exportação, sobrevivência e diversificação de exportações. A próxima pergunta é “por quê”? Este trabalho identifica três tipos particulares de restrições críticas e falhas subjacentes de mercado que impedem que as PMEs da ALC entrem no mercado global e prosperem em base sustentável.

O primeiro conjunto de gargalos é externo. Os custos e limitações de fatores exógenos à empresa são discutidos no Capítulo 3. Um deles são os custos irreversíveis de ingresso no mercado — ou custos iniciais necessários para que uma firma entre em um determinado mercado de exportação —, que tendem a afetar desproporcionalmente as PMEs. O nível de investimento varia conforme fatores como mercado de destino e aprendizado entre firmas dentro de vários setores, e sua análise fornece informações importantes para se administrar essa barreira crítica.

As PMEs da ALC também enfrentam custos altos para exportar em decorrência de infraestrutura inadequada de transporte, demora em desembarçar mercadorias na alfândega e custos altos de frete. Esses “custos de comércio” são especialmente onerosos para as PMEs porque em baixa escala eles tornam não econômicas as iniciativas de exportação. Além disso, as PMEs não têm agilidade suficiente para buscar investimentos que no final elevarão os lucros por unidade.

As PMEs da ALC também lutam com os custos de cumprimento das regras do comércio internacional. Essas barreiras são cada vez mais sérias em vista da proliferação de padrões internacionais e de acordos regionais de comércio, cada um deles com seu conjunto específico de regras de origem e outros critérios de acesso ao mercado. As PMEs da ALC têm pouco tempo e seus recursos são limitados para entender complexas normas públicas e privadas que variam de mercado para mercado. São ainda menos capazes de investir na obediência a essas normas, que abrangem da certificação à rastreabilidade de mudanças básicas nos processos de produção.

As PMEs da ALC também enfrentam sérias assimetrias e lacunas de informação ao servir mercados globais. As limitações de informação ocorrem em ambas as direções. Por um lado, as PMEs exportadoras têm dificuldades

para adquirir e interiorizar informações básicas sobre demanda do mercado, confiabilidade de parceiros, necessidades dos compradores, alternativas logísticas, estândares *de facto* de produtos e outros fatores chave. Por outro lado, os compradores do exterior podem não ter informações sobre a reputação do exportador latino-americano e a qualidade e características de seus produtos, forçando-os a depender da percepção do país do exportador.

O segundo grupo de limitações à internacionalização das PMEs na ALC é interno à empresa. O Capítulo 4 examina os fatores determinantes de êxito, intrínsecos à firma, comuns às PMEs exportadoras e analisa por que apenas uma parcela das PMEs mais eficientes entra no mercado de exportação e é bem-sucedida, como as PMEs menos eficientes podem melhorar sua produtividade em relação aos mercados globais e o que pode ser feito para aumentar o número de empresas bem-sucedidas. A análise enfatiza a importância de ativos essenciais: uma administração com experiência internacional e um conjunto de capacidades difíceis de constituir — entre elas metodologias para controle de risco e incerteza; capacidade para desenvolver relacionamentos de alta confiabilidade e contato contínuo com redes e compradores chave; e a criação de processos adaptativos e inovações de produto mediante a melhoria de tecnologias existentes e conhecimento codificável.

Já possuem várias dessas capacidades as firmas que “nasceram globais” — empresas recém-criadas, em geral baseadas em países com economias pequenas e pouco integradas ao mercado global, e que se internacionalizam com incrível rapidez e virtualmente são bem-sucedidas na largada. Os ativos e as capacidades apresentadas neste capítulo parecem distinguir com regularidade as PMEs exportadoras bem-sucedidas daquelas que não se saem tão bem. As PMEs da ALC tendem a não dispor desses ativos e capacidades. O capítulo mostra que, quanto mais a PME desenvolve integralmente cada um desses determinantes e consegue investir na sua melhoria, maior a chance de êxito nas exportações.

O terceiro desafio à internacionalização das PMEs da ALC de que trata o Capítulo 5 é o acesso a financiamento, combustível essencial ao crescimento e internacionalização das PMEs e que frequentemente não está disponível. As PMEs com fluxo de caixa mais sólido e acesso a crédito bancário exportam mais cedo do que suas congêneres com crédito restrito, oferecem maior variedade de bens e se expandem para novos mercados de exportação. Exportações bem-sucedidas, por sua vez, melhoram o acesso das PMEs ao capital.

Na ALC, a situação do financiamento não é nem muito boa nem muito ruim. Em comparação com mercados semelhantes em outras regiões em desenvolvimento, as PMEs da ALC tendem a ter mais acesso a financiamento bancário, e os bancos estão cada vez mais dispostos a fazer empréstimos às PMEs. O financiamento bancário na região, porém, tem custos proibitivos: as PMEs da ALC enfrentam exigências de garantia e margens líquidas de juros das mais altas do mundo, e essas firmas pagam também taxas de juros significativamente mais altas do que suas congêneres maiores. Além disso, fontes alternativas de financiamento, como venda de ações, crédito de fornecedor e financiamento de cadeia de fornecimento, requerem mais desenvolvimento na ALC a fim de beneficiar um grupo muito maior de PMEs da região.

### Como fazer diferença

As PMEs da ALC enfrentam diversos obstáculos à internacionalização; ainda assim, muitas empresas ainda conseguem suplantar as adversidades. Políticas públicas podem desempenhar um papel de destaque ao reduzir as falhas de mercado que restringem a internacionalização das PMEs da ALC, e assim expandir o número de PMEs que exportam e todas as suas exportações.

Este estudo argumenta que as políticas públicas devem se concentrar em três aspectos: encorajar a maior entrada de PMEs nas exportações; apoiar a sua sobrevivência nos mercados internacionais; e encorajar a diversificação de suas exportações, uma das chaves para sua sobrevivência. As políticas públicas deveriam mitigar os custos, riscos e outros gargalos, e aumentar os ganhos de entrada e permanência no comércio exterior. É essencial que as intervenções não envolvam todas as PMEs, mas apenas aquelas que tenham mais chance de ingresso e crescimento no mercado global. E o enfoque precisa ser integrado. Não existe uma receita única para o êxito da internacionalização das PMEs; ao contrário, são necessárias soluções holísticas, desde a aquisição da capacidade de exportação concebida com uma profunda compreensão dos fatores determinantes do sucesso exportador, até a diminuição dos custos de transporte e a melhoria do acesso a financiamento. Cada capítulo sobre os obstáculos à internacionalização termina com um conjunto detalhado de recomendações de política.

Existem muitos meios de estruturar e sequenciar as intervenções. As experiências e melhores práticas internacionais podem guiar os formuladores de políticas latino-americanos e outras partes interessadas. Este

trabalho analisa mecanismos internacionais diversos e inovadores de apoio à promoção e financiamento de exportações que podem ser aplicados à América Latina. Incluem-se entre esses mecanismos os seguintes:

- **Intercâmbio de conhecimento e experiência.** Existe, hoje, ampla evidência empírica de que os exportadores podem inspirar e ajudar concretamente outras firmas a exportar, transmitindo conhecimentos sobre processos e mercados de exportação. Mas essas externalidades não ocorrem por si sós. São necessárias intervenções de política para torná-las sistemáticas, em escala e com impacto. Alguns exemplos podem incluir arranjos produtivos virtuais e “iniciativas de mobilidade” para internacionalizar a força de trabalho. O setor público pode não apenas proporcionar o local para esse tipo de transferência de conhecimento, mas também desempenhar um papel importante para compensar os exportadores pelo conhecimento gerado e não remunerado para os não exportadores.
- **Conhecimento regional combinado.** Existem excelentes oportunidades de combinar os recursos nacionais e regionais para construir portais de informação altamente acessíveis e fáceis de usar para guiar as PMEs exportadoras e os aspirantes ao setor de exportação. Seria particularmente útil um portal de informações que congregasse num só local toda a variedade de normas e padrões relacionados a comércio exterior, mercados de exportação estrangeiros e financiamento de exportações. Um portal desse tipo, com um formato acessível aos negócios, deveria ser divulgado amplamente entre as PMEs da ALC. ConnectAmericas do BID é um passo importante nessa direção.
- **Desenvolvimento de capacidade em escala e sob medida.** Cada exportador enfrenta circunstâncias diferentes. Por isso, uma orientação genérica tem utilidade limitada. E embora a gestão de caso individualizada possa funcionar, principalmente quando transmitida a toda a cadeia de apoio, ela é reconhecidamente difícil de aplicar em escala. Além do mais, as capacidades específicas no cerne da internacionalização bem-sucedida das PMEs intrinsecamente baseiam-se em aprendizagem, são incrementais e requerem aperfeiçoamento contínuo. Tudo isso aponta para uma nova oportunidade de ir além do treinamento restrito a uma sessão. Essa abordagem alavancaria tecnologia e daria aos gerentes das PMEs acesso a uma ampla gama de avaliações essenciais, ferramentas para tomada de decisões e atividades

de aprendizagem, com controle sobre seu engajamento contínuo na aprendizagem durante a trajetória exportadora.

- **Ação coordenada de governos e partes interessadas.** Muitas vezes os recursos e esforços para ajudar a internacionalização das PMEs se dispersam entre diversos órgãos governamentais e grupos interessados. Para ser bem-sucedida, a internacionalização das PMEs requer soluções holísticas e integradas, e isso deveria estar refletido no planejamento, organização e implementação do apoio. Por exemplo, deveria haver uma coordenação estreita entre os órgãos encarregados de resolver diferentes facetas dos desafios que as PMEs globalizadas enfrentam, entre eles a promoção de exportações, políticas de inovação e desenvolvimento econômico, para citar apenas alguns. De modo semelhante, existem oportunidades para construir sinergias entre as várias entidades que fornecem reforços de crédito às PMEs, como os órgãos de crédito à exportação e financiamento e desenvolvimento das PMEs.

Os capítulos 7 a 9 deste estudo identificam estratégias de ação imediata especialmente adequadas à região e destinadas a catalisar a internacionalização das PMEs e ajudar a maximizar resultados com recursos de apoio limitados. Essas estratégias baseiam-se nas vantagens comparativas da região e incluem as seguintes três áreas:

- **Aceleração da participação de qualidade das PMEs da ALC em cadeias globais de valor.** Com uma presença substantiva de empresas multinacionais na região, as PMEs da ALC têm a oportunidade de fornecer para cadeias globais de valor, um dos melhores passos iniciais para a internacionalização de empresas. As PMEs podem se beneficiar da associação com empresas globais, que tendem a ser exigentes e exercem pressão sobre os fornecedores para melhorar a qualidade, diminuir custos, especializar-se e adaptar-se e inovar constantemente. As PMEs fornecedoras também podem se beneficiar com fluxos de informação, transferência de tecnologia e oportunidades de aprendizagem com a multinacional e/ou seu fornecedor principal. Além disso, ser fornecedor de um grande cliente pode permitir que a PME produza em maior volume e empregue economias de escala. As PMEs da ALC enfrentam agora desafios para assumir novos riscos e investimentos, tendo frequentemente dificuldade para tornar-se fornecedoras. Uma vez que o façam, podem não colher os benefícios. Há

várias intervenções de política destinadas a expandir a participação de qualidade em cadeias globais de valor, como: treinamento em sistemas e centros logísticos de tecnologia que ajudam as PMEs a respeitar padrões de qualidade rigorosos; iniciativas de promoção de ação coletiva para expandir o acesso e melhorar a capacidade; e apoio para reduzir o que podem ser enormes pressões sobre o fluxo de caixa das PMEs por meio de financiamento de cadeia de fornecimento.

- **Alavancagem da diáspora hispânica nos EUA para impulsionar as exportações das PMEs da ALC.** As PMEs da ALC estão excepcionalmente bem colocadas para conquistar mais negócios em um dos mercados de crescimento mais rápido no mundo hoje — o mercado hispânico nos Estados Unidos. Com ambos os segmentos de consumo e de negócios prosperando, esse mercado apresenta vantagens únicas para as exportações da região. Tem em comum um compromisso preponderante com a língua espanhola e também com a relevância cultural. Exige padrões diferenciados de aquisição, tecnologia e mídia que permitem um marketing direcionado. Está ao alcance da América Latina conquistar o mercado da diáspora hispânica nos Estados Unidos: as PMEs de outra região do mundo teriam dificuldades para servir esse mercado em larga escala. As economias da ALC poderiam fazer muito mais para ajudar as PMEs a abordar esse mercado gigante, como estabelecer relacionamentos influentes dentro da diáspora para acelerar a internacionalização das PMEs, desenvolver um acervo de informações em profundidade e ajudar as PMEs exportadoras a buscar opções de financiamento para penetração no mercado dos Estados Unidos.
- **Ajuda às PMEs para alavancar o comércio eletrônico através das fronteiras.** Um dos meios mais poderosos para que as PMEs da ALC alcancem os mercados globais é o comércio eletrônico. A venda *on-line* reduz as distâncias físicas, culturais e de informação que limitam o comércio através das fronteiras. O lado regional da oferta promete: comparadas com boa parte do mundo em desenvolvimento, as PMEs latino-americanas estão bastante bem conectadas à Internet. E a demanda está crescendo a olhos vistos: o mercado *on-line* intrarregional está em franca expansão, mas as PMEs da ALC ainda não exploraram inteiramente essa oportunidade de exportação *on-line*. As empresas da região precisam estar informadas sobre os benefícios do uso da Internet para promoção de seus negócios e tirar vantagem desse potencial para a internacionalização. Esses benefícios incluem a identificação de



mercados e clientes estrangeiros, a comercialização de produtos e serviços para clientes no exterior e o uso de pagamentos *on-line*. A região deveria também garantir que as PMEs da ALC tenham acesso equitativo ao espaço cibernético, controlem os impostos e taxas sobre as compras on-line, e que os pacotes sejam totalmente rastreáveis nos sistemas postais.

Este trabalho, com certeza, não é a última palavra em internacionalização das PMEs na região latino-americana. Há muito mais espaço para pesquisas empíricas adicionais sobre os gargalos específicos à internacionalização das PMEs da ALC e para desenvolvimento adicional de soluções e ferramentas práticas a ser postas em ação para desencadear oportunidades de crescimento da internacionalização das PMEs. É nossa esperança, porém, que este estudo demonstre a enorme oportunidade representada pela internacionalização das PMEs da ALC para as economias e os cidadãos da região, e inspire pensamentos e coordenação inovadores sobre a melhor maneira de agarrar a oportunidade — começando hoje. Já se conseguiu muito na região. Num período de endurecimento da competição global por participação em mercados de exportação e por investimentos estrangeiros diretos, esses esforços agora terão que ser acelerados. O resultado certamente valerá o esforço.



# **Trends and Impacts of LAC SME Internationalization**

SECTION





# Introduction

## Purpose of the Report

Nations around the world have identified exports as a key for economic growth. This is clearly the case in Latin America and the Caribbean, where trade has become the lifeblood for practically all LAC economies following two decades of structural reforms, extensive trade liberalization, and the formation of free trade agreements with leading economies.

The region's trade expansion has mainly been driven by large companies: multinationals and large, highly internationalized Latin American companies (multilatinas), which often make the bulk of their sales overseas. However, small and medium-sized enterprises (SMEs) are notably underrepresented in the region's external sector despite their importance as a backbone of LAC economies and a source of employment for millions of people. SMEs constitute more than 95 percent of the region's companies, but only 13 percent of these firms engage in exports. In addition, LAC SMEs that do export tend to sell only a few products to a very small number of markets. These patterns not only stifle the potential for growth among LAC SMEs that could be attainable through gains from trade; they also render SMEs more vulnerable to domestic business cycles.

Countries in Latin America and the Caribbean stand to score significant growth gains by fostering SME internationalization, particularly by focusing on SMEs with a strong potential to succeed in international markets. These LAC SMEs are a vast reservoir of latent potential that has yet to be tapped as a means for achieving export-led growth, greater productivity, economic diversification, and job creation. SMEs that succeed in export markets will enable LAC countries to significantly expand and diversify their exports. Recent research around the world also shows that internationalization enables SMEs to become more productive, innovative, and competitive, thus offering an opportunity for LAC firms to grow into large companies that generate employment for thousands of people. Yet many LAC economies lag behind comparable emerging markets in SME export participation, diversification, and export sales.

SME internationalization is a relevant growth opportunity for Latin America and the Caribbean. The question is how to best support and

accelerate it. This report seeks to provide answers. We look at each of three key sides of the issue: the state of SME internationalization in Latin America and the Caribbean; the opportunities and constraints for the regional SMEs to internationalize; and practical recommendations for policymakers, companies, and practitioners to accelerate SME internationalization. In particular, the report aims to answer several critical questions:

- Why does SME internationalization matter for LAC economies? What is the impact and importance of SME internationalization to LAC's growth and development?
- What is the state of SME internationalization in LAC? How internationalized are LAC SMEs today?
- What are the main constraints to SME internationalization in the region, both the external policy and economic barriers as well as SMEs' internal management and operational capabilities?
- What global best practices and policies can best further SME internationalization in LAC? What policies and programs to accelerate SME internationalization have been tested and tried in such regions as Asia, Europe, and North America, and how can these innovations be applied to LAC SMEs?
- What are the key policy and programmatic priorities for LAC governments and other stakeholders to advance SME internationalization in the region?

By analyzing these key questions, this report seeks to spur cutting-edge thinking among LAC policymakers and business leaders on structuring support, programs, and initiatives to catalyze and expand SME internationalization in LAC. While grounded in rigorous academic literature and fresh analytics, the report is presented in a nontechnical fashion. We do this to make the report's insights and recommendations readily accessible and actionable among the many relevant regional stakeholders.

Our findings strongly suggest that successful and sustainable SME internationalization requires a paradigm shift. LAC must turn away from a granular focus on isolated support mechanisms that may or may not place SME priorities at the forefront, and embrace a holistic and coordinated set of national economic and trade policies along with requisite managerial and operational practices within SMEs and targeted institutional innovations.

## New Context

It is useful to take a step back and assess the present status of SME internationalization. The situation today is dramatically different from that prevailing in the 1980s, when the region embarked on structural reforms, and even from the state of affairs at the start of the new millennium. Five dynamics shape the opportunities and challenges for SME internationalization in LAC:

- **Globalization.** Trade and investment liberalization, reduction of trade costs, and the rise of global value chains over the past few decades have dramatically expanded opportunities for LAC companies to internationalize. At the same time, globalization has resulted in stiffer competition in overseas as well as domestic markets: LAC SMEs today are competing head-on with companies from neighboring LAC markets as well as numerous other emerging and advanced economies.
- **Multinationalization.** Global production and sourcing by the world's more than 80,000 multinational companies (MNCs) has proliferated remarkably. In 2012, developing economies for the first time attracted more foreign direct investment than developed economies. This sea change in trade and production patterns has vastly increased opportunities for emerging market SMEs to participate in global value chains as suppliers. However, MNCs are also exacting business partners, demanding that suppliers deliver quality on time and meet extensive international standards.
- **Rise of the global middle class.** Global consumer markets have expanded remarkably, and are poised to double in size in the next decade. The rise of some 2 billion new middle class consumers across the emerging world opens up multiple customer bases with spending power for LAC companies to serve, including in the intra-regional markets. At the same time, the rise of global consumers creates unprecedented strategic and operational imperatives for companies seeking to cater to these massive opportunities. Adding to the complexity, many of these demands are changing rapidly, as are market segments.
- **Digitization.** The Internet already has 2.4 billion users; in 2020, over 5 billion new users are expected to log on. Growth in Internet use is especially high in the emerging markets, including in the LAC region. The end of the digital divide paves the way to unprecedented opportunities

for even the smallest LAC companies to find new customers, attract buyers, source foreign inputs and services, and advertise and sell their products globally—all at a lower cost. Yet internationalization through e-commerce does not obviate the traditional demands of trade, including the need to localize and price the export products and services to new markets, overcome communication barriers, and stand out from the pack as a credible and quality supplier.

- ***The certainty of uncertainty.*** The global economy is shrouded in uncertainty. While the epic Great Recession is over and globalization continues to advance, there are concerns about lackluster growth prospects in the advanced economies, credit bubbles and economic cooling in the leading emerging markets, and fears of a future of currency wars and protectionist policies that would undo the gains from the liberal global trading system of the past seven decades. With all nations vying for an edge in world markets, already-intensive competition will only continue to escalate.

This global context has important implications for strategies to promote SME internationalization in LAC. It places a premium on policies and practices that enable companies to quickly adjust to the rapid changes in the global competitive landscape, innovate to discover and cater to emerging consumer demands and multinational companies' standards, and build the resilience needed to withstand shocks afflicting clients, export markets, and supply chains.

The global context also places a premium on LAC's comparative advantages and unique strengths. These include liberalized access and relative proximity to the largest market in the world in the case of most Latin American economies; a vast US-based Diaspora with multiple consumer and business segments that share a preference for Spanish-language communications along with tastes and needs that reflect those of the region; deep intra-regional integration that offers export opportunities in neighboring nations; and a significant presence of multinational companies that local SMEs can supply.

At the same time, LAC SMEs also struggle against several barriers: elevated trade costs, or costs associated with moving goods to and from ports and airports and through customs; inadequate access to capital for internationalization; and limited management and operational capabilities essential for competing on the global stage. The region has fallen behind Asian emerging economies in technology and innovation that are critical in today's



global commerce. And there are glaring gaps and disparities in the basic ingredient of productivity: education and training.

In light of these challenges, it is clear that further SME internationalization will not take place automatically. Clearly, the hurdles for SMEs to serve international markets are typically far steeper than they are for large companies. For example, SMEs lack the same access to capital, globally experienced management, and global contacts as do large firms. At the same time an SME's required investment as a component of the firm's overall outlays are substantially greater than for large firms. SMEs from emerging economies face even higher hurdles along several essential fronts, such as the acquisition of highly specific information and the capacity for continual innovation; these often force SMEs to stretch far beyond the practices they use to serve the domestic market.

Recognizing the unique challenges faced by SMEs, LAC governments have developed policies and interventions to expand SMEs' export participation and internationalization. Yet these efforts can be stepped up in quality and performance, and geared to address the full suite of market failures and associated challenges and stakeholder roles that restrain globalizing SMEs.

This report aims to help guide and accelerate these efforts by identifying the specific dynamics affecting LAC SMEs and by defining suitable policy options that address the region's unique opportunities and challenges in today's rapidly evolving global environment. This report also seeks to contribute to the rapidly growing body of literature on SME internationalization around the world. In the past few years, several governments have surveyed and studied SMEs, while academics have advanced understanding of the key determinants of firms' ability to internationalize and the impact of internationalization on them. This report draws on this body of literature while breaking new ground by integrating diverse research in such areas as SMEs' intra-firm export success drivers, quality participation in global value chains, use of regional trade agreements, and utilization of technology and the Internet to sell goods and services to overseas regions.

## Organization of the Report

This report consists of the following three parts:

- The first part is a diagnostic. It details the state and effects of SME internationalization in Latin America, and provides in-depth analysis

of the effects and benefits of SME internationalization to the region's firms and economies.

- The second part is written as a context for action. It analyzes the key determinants, levers, and constraints to LAC SME internationalization and compares different kinds of firms, sectors, and regional economies, where possible. This section also presents policy recommendations aimed at each of the challenges identified.
- The third part is intended to diversify and integrate the menu of policy options. It offers selective, concrete strategies to benefit a range of LAC SMEs by sector, country of origin, and/or stage of internationalization. The goal is to stimulate new thinking on practices, tools, and instruments that can encourage and accelerate SME internationalization.

The report concludes with high-level policy guidance on advancing SME internationalization in Latin America and the Caribbean.

# How Internationalized Are LAC SMEs?

# 1

Internationalization is hardly a new growth strategy in Latin America and the Caribbean. The region's economies have long pursued growth through trade, and nearly all of them are also highly dependent on trade. However, the region's trade is still driven by large firms and multinationals. More than half of most LAC economies' exports are generated by the top 1 percent of exporters. Small and medium-sized enterprises (SMEs) make up more than 90 percent of firms in the LAC region, but relatively little is understood about their role in the region's trade. Questions include the following:

- How internationalized are LAC SMEs compared to SMEs in other regions of the world?
- How diversified are LAC SMEs' export markets and products?
- Are internationalized LAC SMEs different from non-internationalized firms?
- What is the role of SMEs in the region's export sector?
- Are LAC SMEs internationalizing further? Or are they retrenching?

This chapter provides answers to these questions. We analyze firm-level data globally and offer an assessment of the state of SME internationalization in Latin America and the Caribbean. Part one describes various modes of internationalization, many of which are addressed in this report. Part two takes the pulse of SME internationalization in the LAC region, analyzing the level of SME internationalization in different LAC economies as well as the characteristics and performance of SME exporters. Part three assesses key dynamics among LAC exporters, such as their export markets, product diversification, frequency of entry and exit, and survival strategies in the export game. Part four summarizes and extends the key findings.

## I. What Is Internationalization?

Firms internationalize in the following ways:

- **Direct exporting:** The firm ships its product directly to the export market, whether to distributors or sales representatives in that country

or to the firm's end customer. Direct exporting allows the SME to select its foreign markets and choose its representatives. Relative to other modes of internationalization, it generally provides for the greatest control of the relationship with the foreign customer, along with related customer and market intelligence gathering. If a foreign-based representative or a distributor is involved in the sale, that actor typically performs one or more key activities, such as maintaining inventory, marketing and market intelligence gathering, and/or providing support and after-sales service to the buyer.

- **Indirect exporting:** The firm delegates both customer relationship management and the export process to an intermediary that is not located in the foreign country of sale. Typical intermediaries are export management companies and export trading companies. In this scenario, the SME has no control over its products in the foreign market, or even over which foreign markets will be targeted. As such, it will learn little about the process of selling and operating overseas.
- **Licensing:** In some sectors such as IT, entertainment, and manufacturing, firms may also internationalize via licensing. Here, the SME (the 'licensor') grants limited rights or resources to a foreign company (the 'licensee') to manufacture and sell the SME's product for a fixed term in one or more specified markets, whether on a stand-alone basis or as a component integrated into the licensor's suite of products. This highly customized relationship, which may or may not be exclusive, is dependent on technical knowledge transfer from the licensor to the licensee.
- **Importing:** The firm identifies a foreign supplier and makes arrangements to obtain the goods from the foreign firm. The firm may use these goods (e.g., machines and equipment) to manufacture its final products or as inputs into final products.
- **Strategic alliances and joint ventures:** A cross-border strategic alliance is a cooperative agreement between firms from different nations aimed at furthering growth. These relationships require more extensive partnering and pooling of resources than those made possible by less collaborative relationships. They may include shared technology and research, joint product development, a shared risk-reward distribution arrangement, or a market entry and/or joint sales consortium.
- **Inbound foreign direct investment (FDI):** A foreign firm takes a partial equity position in a regional SME, acquires the SME outright, or establishes a greenfield wholly-owned subsidiary. Typically, FDI is a

means for expanding production or distribution capacity in the region or a specific LAC country.

- **Outbound direct investment and franchising:** An SME may also set up production or distribution organizations overseas as a means of expanding production or distribution capacity. In certain industries such as restaurants, hospitality, and retail, franchising is a variant on this theme. As in the licensing model, the regional SME (the franchisor) does not directly control operations or sales in the foreign market, but rather, provides such rights to semi-independent business owners in that market (the franchisees). Franchisors provide franchisees a broad set of rights and resources, including the use of its intellectual property, business formats, and systems, while the franchisee pays the franchisor a variety of fees and royalties. The franchisee will then run the business in the foreign market in much the same way it is done by the franchisor in the home market.
- **Insertion into global value chains:** A firm sells directly to a large company present in the firm's domestic market. Or the firm is a second-, third-, or fourth-tier supplier to the large company, selling directly to higher-tier suppliers. In all of these cases, the firm is participating in the global value chain of a much larger company, typically but not always a foreign multinational corporation. A share of the large company's production may be exported to foreign markets.

This report analyzes SME internationalization by focusing primarily on two of the above modes: direct exporting and insertion into global value chains. We take this focus for three strategic reasons:

- There is a rich but often scattered and theoretically disconnected literature on SME exports. This report draws on the existing body of knowledge, aggregates and analyzes this knowledge, and explores the impact, need, and mechanisms for helping LAC governments strengthen SME internationalization.
- Insertion into GVCs within the domestic market, i.e., becoming a supplier to a multinational firm in one's own country. This is one of way in which regional SMEs can and do internationalize.
- Exporting and insertion into GVCs are related. As this report will show, accession into global value chains can be a particularly effective strategy for SMEs in "graduating" to becoming exporters.

The various modes of internationalization are not mutually exclusive. Rather, they tend to complement each other. For example, the most prolific exporters are often also voracious importers. The different modes can also be sequential. Indeed, just as there are several modes of internationalization, there are countless, complex internationalization pathways. In addition, SMEs face a range of unique obstacles and opportunities that shape their internationalization trajectories. For example, many LAC SMEs export only one product to market, and do so only after much trial and error. Others find themselves struggling on the global stage, entering new markets, dropping out, and reentering at a later time. Still others may test exporting in the neighboring LAC markets before setting out to sell to large developed country markets, although only a minority of such new market entries succeed.

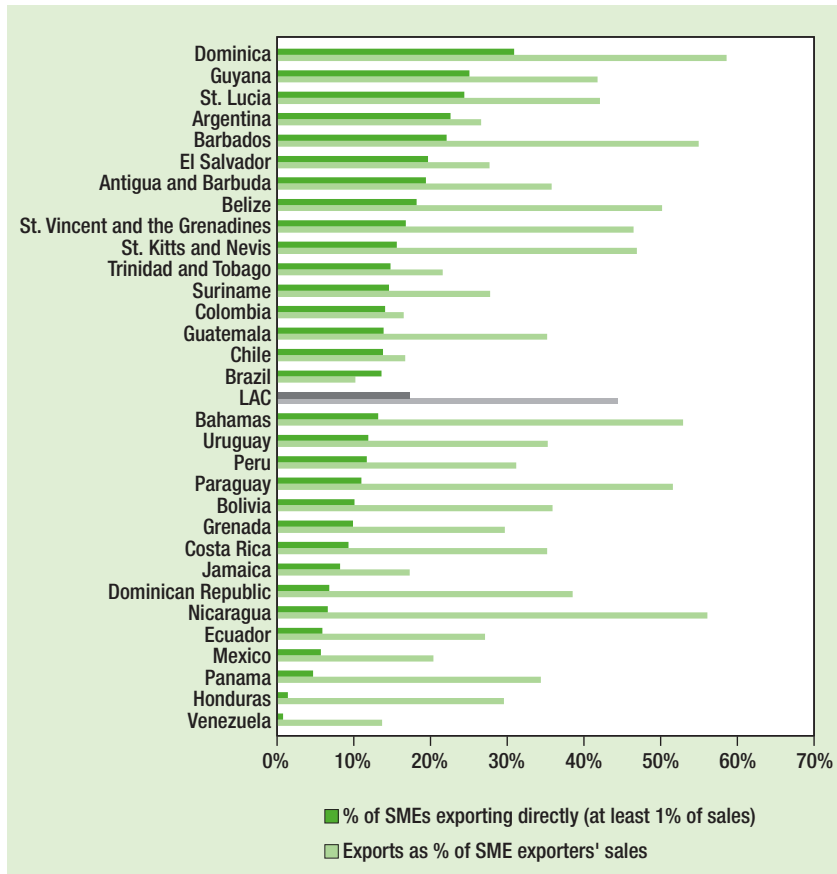
SME exporters are also dependent on their environment and are disproportionately exposed to external shocks. Take as an example the drying up of trade finance in the recent financial crisis: large firms outcompeted SMEs in the search for the scarce capital.

In short, for most SMEs internationalization is a zigzag and stop-and-go process subject to multiple external challenges and internal learning. The next chapters examine these challenges in detail. Then we will take a step back and abstract from the individual experiences to offer a macro perspective of SME internationalization in Latin America and the Caribbean.

## **II. State of SME Internationalization in Latin America and the Caribbean**

In most Latin American countries, SMEs are defined as companies with fewer than 250 employees. Firms in this segment typically make up well over 90 percent of firms in LAC countries. This proportion is similar to such economies as the European Union (90 percent of manufacturing firms) and Turkey (94 percent), and well above the levels in the United States (75 percent) and Korea (52 percent).<sup>1</sup> SMEs are also a critical source of growth and employment for millions of people in Latin America and the Caribbean. What is more, the importance of LAC SMEs is often underestimated because the vast majority of such enterprises operate out of sight in the region's vast informal sector.

If SMEs are the backbone of the region's economies, are they similarly important in the region's exports? How internationalized are LAC SMEs? Are they more or less internationalized when compared to SMEs in other world



**FIGURE 1/**  
Percent of SMEs  
Exporting Directly (at  
least 1% of their sales)  
by Country, 2009–10

Source: Enterprise Surveys.

regions? And what makes an SME exporter, i.e., how are SMEs that export different from non-exporters? The following discussion will provide answers.

### A. LAC SMEs' Export Participation

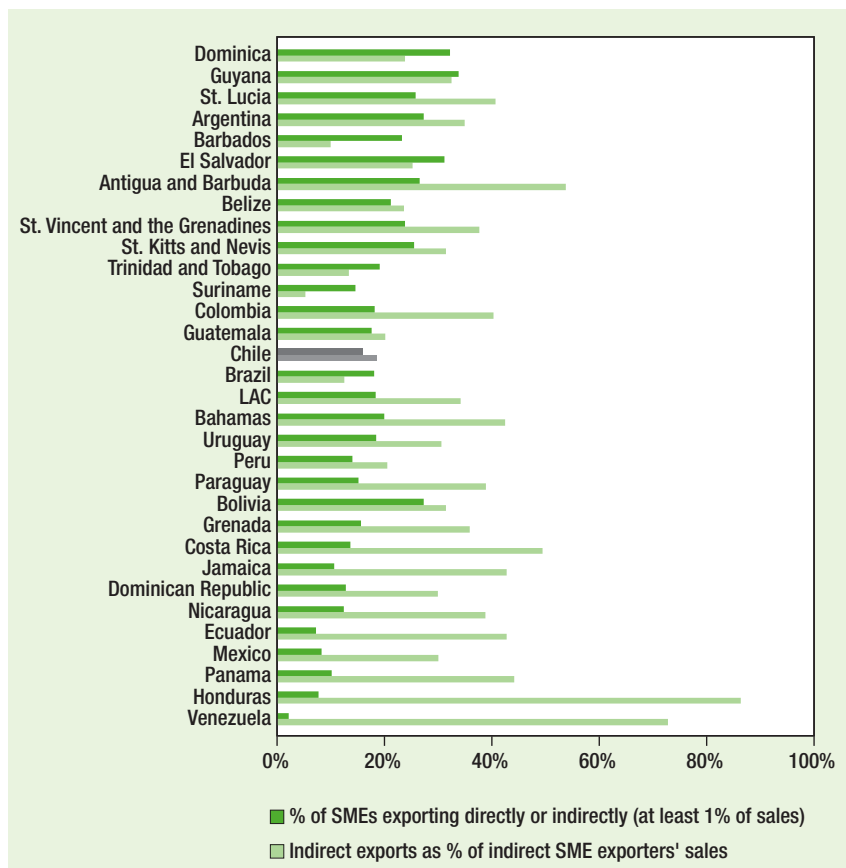
Despite their prominence in LAC economies, SMEs remain underrepresented in the region's export sector.<sup>2</sup> Only 13.4 percent of the region's SMEs export, i.e., derive at least 1 percent of their sales from foreign markets (Figure 1). SMEs in El Salvador, Argentina, Uruguay, and Colombia are particularly internationalized. The share of SMEs that export is higher in the small Caribbean nations and also in Argentina, where several of the country's midsize firms export. Conversely, export participation is very low in Mexico, Panama, Honduras, and Venezuela; in these economies, fewer than 6 percent of SMEs export. LAC SMEs that do export derive about a third of

their sales from exports, giving them a weighted export intensity average (as per Enterprise Survey data) of about 15 percent; the unweighted average intensity is about 33 percent. Export participation and intensity correlate at the country level, reflecting the critical need for firms in smaller economies to seek growth beyond home country borders.

If indirect exporters using intermediaries are included in the data, some 18 percent of LAC SMEs export (Figure 2). Indirect exporters make up 5 percent of LAC exporters, which is relatively few compared to other world regions, and indirect exports on average make up 21 percent of their sales.

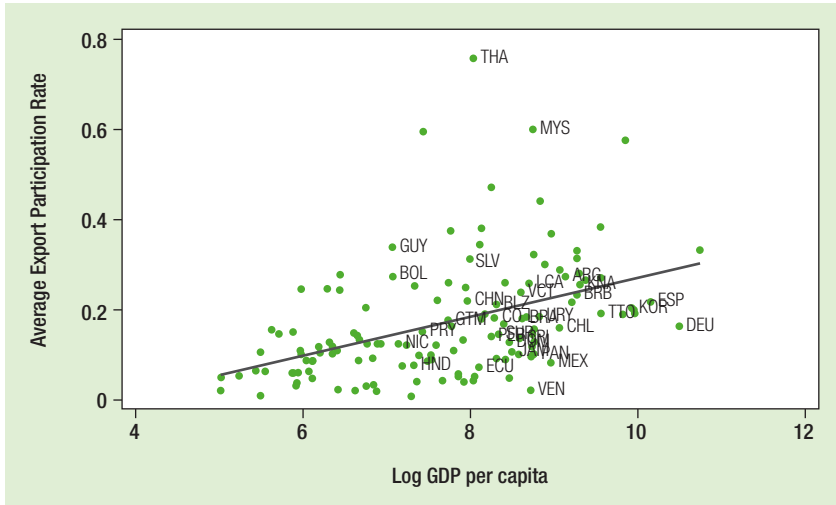
In contrast to other emerging markets and developing countries, LAC SMEs under-export, i.e., they have a lower export participation rate than those in economies of comparable size, such as many East Asian and Eastern European economies (Figure 3). For example, the participation rate

**FIGURE 2/**  
Percent of SMEs  
Exporting Directly or  
Indirectly (at least  
1% of their sales) by  
Country, 2009–10



Source: Enterprise Surveys.

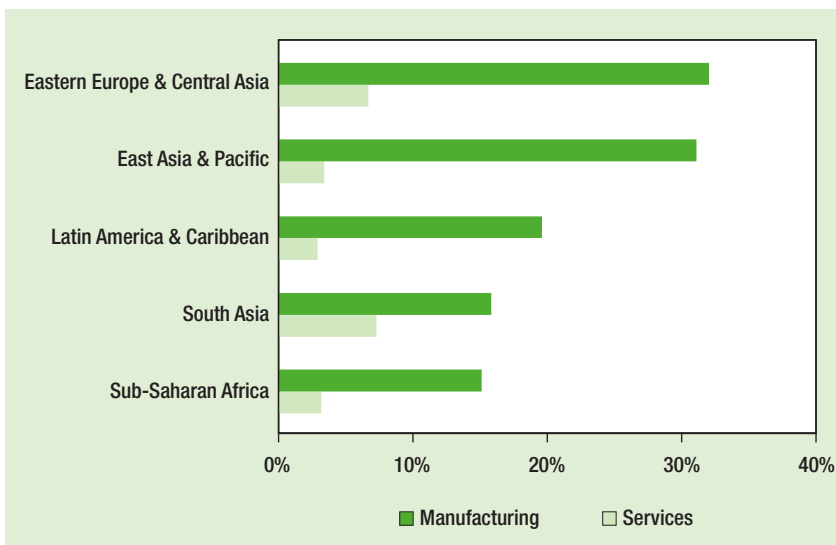




**FIGURE 3/** Percent of SMEs that Export Directly (at least 1% of sales), by Country, 2006–2010

Source: Authors' calculations based on Enterprise Surveys and World Development Indicators.

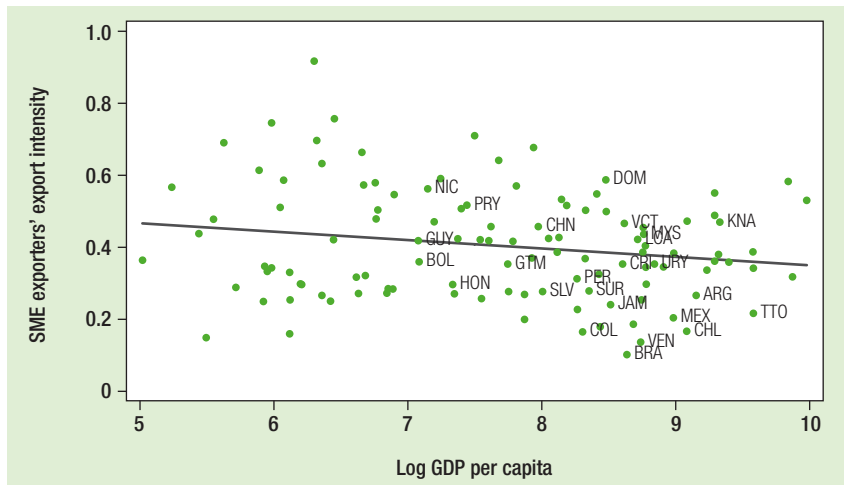
for South Korean SMEs is 18.9 percent, for Thailand more than 47 percent, and for Malaysia 54.7 percent. To be sure, the survey samples for these Asian countries are highly concentrated in manufacturing firms, which are more likely to export than services firms. Yet even comparing manufacturers to manufacturers, LAC SMEs' export participation trails that of East Asia and Eastern Europe (Figure 4).<sup>3</sup>



**FIGURE 4/** Percent of SMEs Exporting Directly (at least 1% of sales) by Sector and Region, 2006–2010

Source: Enterprise Surveys.

**FIGURE 5/**  
**Exporter SMEs' Export**  
**Intensity by Country,**  
**2006–2010**



Source: Authors' calculations based on Enterprise Surveys and World Development Indicators.

Exporters—especially in South America—also have lower export intensities than exporters in countries at similar levels of development (Figure 5).<sup>4</sup> For example, the average SME exporter in Brazil, Mexico, Chile, Colombia, and Jamaica has 10–20 percentage points lower export intensity than SME exporters in such countries as Turkey, and as much as 40 percentage points below export intensities of Portuguese exporters.

### **B. Why Do So Few SMEs Export?**

There are a number of additional common characteristics of export behavior across emerging and advanced markets, one of which relates to firm size.<sup>5</sup> Research shows that larger firms are more likely than small ones to export, export more, and have higher export intensity.<sup>6</sup> One of the key reasons is that size enables firms to cover the high sunk costs involved with export entry as well as export expansions.

Consider a simple framework developed by Melitz (2003) that centers on firm productivity and entry costs required to export.<sup>7</sup> In this framework, in order to sell part of its output abroad, a firm has to pay not only variable costs involved with the transaction (such as shipping and tariffs), but also a fixed entry cost (such as costs involved with identifying new markets and customers and meeting international standards). More productive firms earn higher profits, and hence are better positioned to cover these fixed costs. Thus only a subset of firms that are sufficiently productive and typically also larger will be able to export. SMEs are harder pressed to compete and face

Firm Size	SMEs' Export Participation	SME Exporters' Export Intensity
Small (< 20 employees)	8.5%	21.0%
Medium (20–99)	17.6%	12.7%
Large (100 and over)	32.2%	16.6%

Source: Enterprise Surveys.

**TABLE 1/**  
SMEs' Export Participation  
and Intensity in LAC in  
2009–10, by Firm Size  
(weighted averages)

disproportionately greater entry costs than do large firms. This is the main reason why many SMEs find it difficult to export.

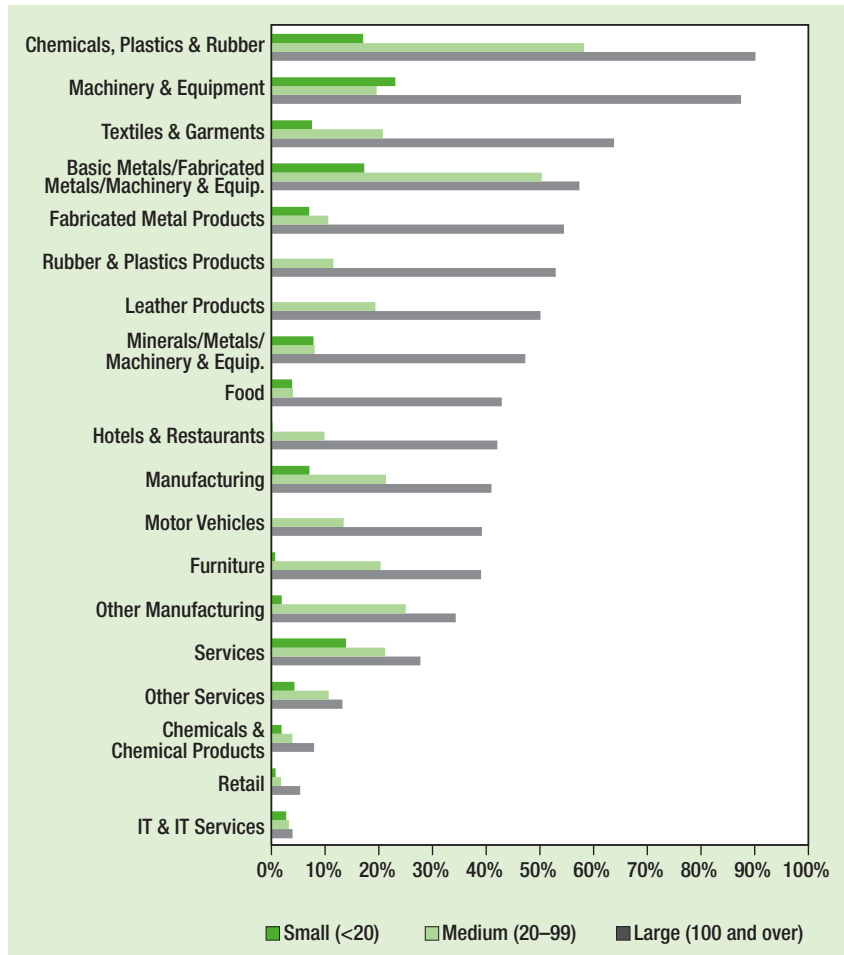
These patterns hold true in Latin America. Only 9 percent of the region's smallest companies—firms with fewer than 20 employees—export, as opposed to 18 percent for medium-sized SMEs (with 20–99 employees) and 32 percent for large SMEs and large firms (with more than 100 employees) (Table 1). Firm size and exporting correlate across all economic sectors in LAC, with a far greater proportion of large firms engaging in exporting than smaller or medium-sized SMEs (Figure 6). Somewhat surprisingly, export intensities are greater for the smallest companies than for medium-sized or large ones.

Most Central and South American countries as well as Mexico have lower SME export participation rates across these three firm size categories than comparable economies in other regions (Figure 7). The export participation rate is particularly low for small and medium-sized Latin American SMEs, trailing far behind such East Asian economies as Thailand and Malaysia as well as Central and Eastern European nations. SMEs in Caribbean nations tend to be more internationalized than comparable economies.

SME exporters' export intensity in LAC by and large approximates the average of other developing and emerging regions (Figure 8). An interesting finding for policy purposes is that once LAC SMEs start exporting, their export intensity seems to be robust; the problem is that many of these firms do not export at all.

**Stylized Fact 1:** LAC SMEs have yet to embrace exporting as a growth lever. Fewer LAC SMEs export than SMEs in comparable economies. Firm size and export participation correlate: smaller SMEs participate less in exporting than do larger SMEs, and overall export less than their peers in other economies. However, LAC SMEs that do export tend to derive a robust share of their sales from exports.

**FIGURE 6/**  
**Percent of SMEs**  
**Exporting Directly (at**  
**least 1% of sales) by**  
**Sector and Firm Size,**  
**2006–2010**



Source: Enterprise Surveys.

Furthermore, the fact that LAC trails other countries suggests that (a) the productivity of SMEs in LAC is generally lower than that of SMEs in other regions, and/or (b) entry costs involved in exporting are larger for SMEs in LAC than for SMEs in other regions. The following chapters explore these possibilities.

### C. LAC SME Exporters' Characteristics

What types of companies in LAC export? Are exporters different from non-exporters?

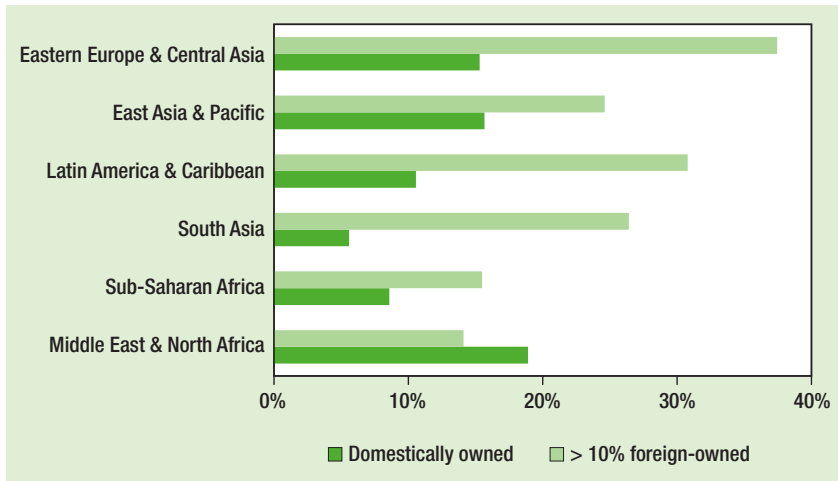
The above analysis shows that patterns of internationalization vary by firm size and sector: exporters are more likely to be larger firms than small





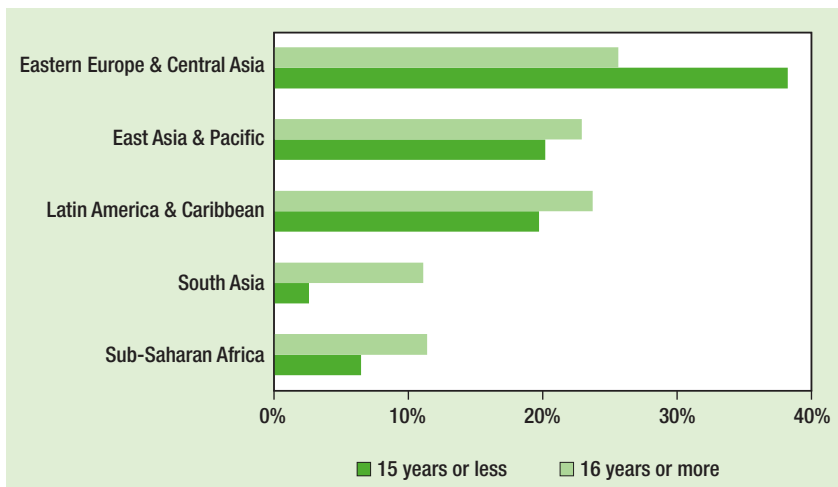
ones, and firms in manufacturing sectors export more than services firms. There are several regularities.<sup>8</sup> Firms with foreign participation are more likely to export than firms that are fully domestically owned; this is the case in most world regions, including LAC (Figure 9). Foreign ownership implies that the firm has ready connections in overseas markets, and may in general be predisposed to internationalization.

Similarly, older companies tend to participate more in exporting than do young ones, simply because they have had more time to grow in the domestic market and test out international markets (Figure 10). The patterns



**FIGURE 9/** Percent of SMEs Exporting Directly (at least 1% of sales) by Ownership and Region, 2006–2010

Source: Enterprise Surveys.



**FIGURE 10/** Percent of SMEs Exporting Directly (at least 1% of sales) by Age and Region, 2006–2010

Source: Enterprise Surveys.

and levels of internationalization for firms of the same age categories are very similar for LAC and East Asia; the exception is Eastern Europe, where companies established after the transition from communism are more internationalized than the older firms.

In addition to these exporter characteristics, research has firmly established that exporters are more productive than non-exporters. This is the case for a number of reasons. For one, the high-performing companies are the ones that self-select into exporting. In addition, exporting leads to a number of gains. One such gain is that revenue diversification across markets reduces the volatility of shipments and vulnerability to downturns in any one market. Another is increased capacity utilization and scale economies due to expanded sales. An additional gain is learning-by-doing, which fosters better managerial practices, innovations, and discovery of new market opportunities. As such, exporters tend to enjoy a premium over non-exporters across various performance metrics. Compared to non-exporters, exporters are typically larger and more productive, have higher sales, pay higher wages, and are more skill-intensive.

Table 2 shows this to also be the case in LAC. Controlling for industry and country fixed effects and for employment, exporters have 55 percent higher sales and 54 percent higher value-added per worker than do non-exporters. They also pay 42 percent higher wages and are 9 percent more skill intensive.

These patterns hold in each firm size category: smallest exporters outperform smallest non-exporters just as large exporters outperform large

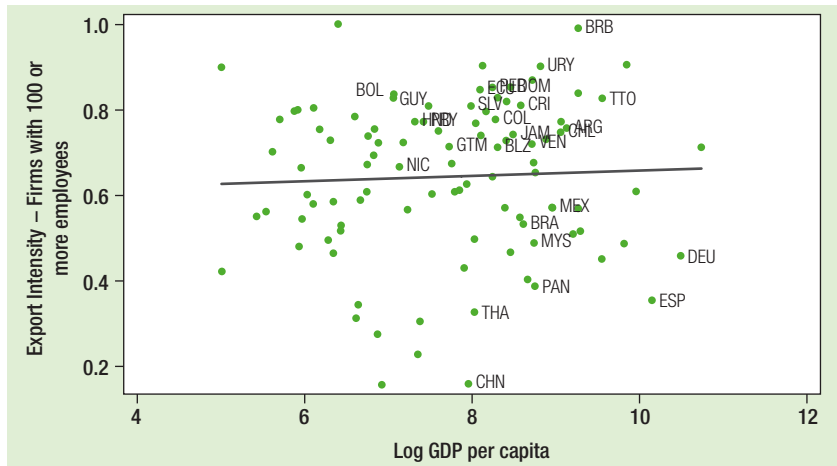
**TABLE 2/**  
**Exporter Premia for LAC**  
**SMEs under Various**  
**Specifications, 2009–10<sup>a</sup>**

	Exporter Premia (1)	Exporter Premia (2)	Exporter Premia (3)
Employment	2.39	2.44	...
Sales	6.10	5.36	0.55
Value added per worker	1.12	0.86	0.54
Wages	0.73	0.57	0.42
Skill per worker	0.06	0.12	0.09
Control variables	None	Industry and country fixed effects	Industry and country fixed effects and Log of employment

*Sources:* Authors' calculations based on Enterprise Surveys.

<sup>a</sup> Data are for 2009 and 2010 for LAC firms. All results are from bivariate OLS regressions of firm characteristic in first column on the dummy variable noted at the top of each column, along with country, establishment size (employment), and sector fixed effects (SIC 2 digits). Employment regressions omit firm employment as a covariate. Skill per worker is nonproduction workers per total employment. All results are significant at the 1 percent level. The figures above are calculated on the basis of regression coefficient as  $\exp(\beta) - 1$ .





**FIGURE 11/**  
Percentage of SMEs  
that Import, by Country,  
2006–2010

Source: Authors' calculations based on Enterprise Surveys and World Development Indicators.

non-exporters. At the same time, the size of the premia increases with firm size: large exporters are more productive vis-à-vis large non-exporters than small exporters are vis-à-vis small non-exporters.

Exporters share further traits. One is that many of them import. Overall, LAC SMEs import more than do their counterparts in comparable economies (Figure 11). Also, the import participation of LAC SME exporters is particularly pronounced: 84 percent of SMEs exporters also import (Table 3). Exporters that import are two-way traders; they make up 10.4 percent of LAC SMEs, and their share is highest in chemicals and plastics (55 percent of SMEs are two-way traders), basic and fabricated metals (32 percent), machinery and equipment (25 percent), and textiles and garments (19 percent).

Imports play an important role in the production of LAC SMEs. On average, 38 percent of LAC SMEs' inputs are of foreign origin. LAC SME

**TABLE 3/**  
Types of  
Internationalized LAC  
SMEs, 2009–2010

	All	Small (< 20 employees)	Medium (20–99)	Large (100 and over)
% of all companies that export	13.40%	3.80%	14.50%	27.60%
% of all companies that import	71.00%	68.90%	69.00%	85.50%
% of exporters that import	83.70%	57.60%	88.50%	87.00%
% of non-exporters that import	70.30%	69.30%	65.40%	85.00%
% of importers that export	14.50%	3.20%	18.60%	28.00%
% of non-importers that export	7.20%	5.20%	5.40%	25.40%
% of all companies that export and import	10.40%	2.10%	12.90%	23.90%

Sources: Authors' calculations based on Enterprise Surveys.

exporters use foreign inputs about 50 percent more intensively in their production than do non-exporters. The share of imports of overall firm inputs tends to be highest in the small LAC economies, such as the Caribbean and Central American nations and Uruguay. In contrast, in the two largest economies, Brazil and Mexico, some four-fifths of SMEs' inputs are domestic.

The heavy importing by LAC SMEs and SME exporters reflects the region's liberalized trade regimes and the relatively limited availability of high-quality domestic inputs, particularly in the smaller economies, as well as some fragmentation of production across borders. It also suggests that importing does not involve significant sunk costs, as opposed to the costs of entry into export markets. This pattern is overall positive: importing enables LAC SMEs to access a larger variety of high-quality inputs at world prices, which, in turn, makes their final products more competitive. Indeed, there is a strong positive relationship between imports and firm productivity: firms that import are more productive.<sup>9</sup>

Imports not only fuel SME exports; importing also can be a precursor to exporting. One typical conceptualization of SME internationalization is the so-called Uppsala model. In this sequential, stepwise model, the firm first imports, then engages in indirect exporting and, subsequently, in direct exporting. Success in the initial or first few export markets leads to further export market diversification and introduction of new products. In this way, a firm enters different markets through sequential steps, expanding into a new market only after having become profitable in its existing markets.<sup>10</sup> In this stepwise, incremental process, the firm gains knowledge, skills, and scale conducive to further expansion.

Eventually the firm may decide to move beyond serving the foreign market as an arm's-length exporter and engage in foreign direct investment to set up production facilities and sales offices in its export markets, in this way positioning itself closer to the end customer. In this step, exporting serves a useful testing function: firms that are uncertain about their ability to earn profits in a foreign market and must decide whether or not to enter that market tend to do so by exporting before engaging in outward foreign direct investment. A study of Belgian companies in 1998–2008 shows that firms' entry in a foreign market is almost always preceded by its export entry.<sup>11</sup>

Internationalized firms, whichever their mode of internationalization, are found to be superior to other firms. Just like exporters, importers outperform their non-importer peers, and two-way traders tend to benefit from the positive effects of both importing and exporting.

	Exporter Premia (1)	Importer Premia (2)	Two-way Trader Premia (3)
Employment	2.46	1.05	2.49
Sales	0.55	0.38	0.50
Value added per worker	0.54	0.38	0.51
Wages	0.42	0.26	0.39
Skill per worker	0.09	0.06	0.03
Control variables	Industry and country fixed effects and Log of employment	Industry and country fixed effects and Log of employment	Industry and country fixed effects and Log of employment

*Note:* Data are for 2009 and 2010 for LAC firms. All results are from bivariate OLS regressions of firm characteristic in first column on the dummy variable noted at the top of each column, along with country, establishment size (employment), and sector fixed effects (ISIC 2 digits). Employment regressions omit firm employment as a covariate. Skill per worker is nonproduction workers per total employment. All results are significant at the 1 percent level. The figures above are calculated on the basis of regression coefficient as  $\exp(\beta)-1$ .

Table 4 shows that LAC SME exporters, importers, and two-way traders all enjoy premia not shared by their non-exporter and non-importer peers. For example, holding country—and industry-specific factors as well as firm size constant, two-way traders have 50 percent higher sales, 51 percent higher labor productivity, and 39 percent higher wages, than do firms that are not two-way traders. The performance of two-way traders approximates that of exporters, given the very high correlation between the two groups. Importers also outperform non-importers by resounding margins. Firms in all three categories also employ many more workers than their non-internationalized peers. Overall, these results suggest that the better LAC SMEs are the ones that internationalize, and that the performance of LAC SMEs is related to their participation in international trade. The Box below examines these patterns in the case of Chile, one of the most internationalized countries in the Americas.

**Stylized Fact 2:** Internationalized LAC SMEs are better companies. LAC SME exporters and importers alike employ more workers, pay higher wages, and have higher sales and labor productivity than their non-exporter and non-importer peers. These patterns suggest that international trade plays a central role in LAC SMEs' performance: high-performing SMEs are the ones that internationalize, and SME internationalization fuels company performance.

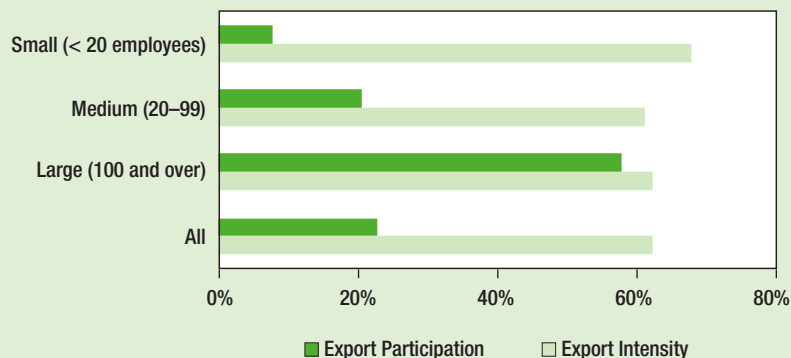
**TABLE 4/**  
**Exporter and Importer**  
**Premia for LAC SMEs,**  
**2009–10**

### Chile's Highly Internationalized High Performers

Chile is one of the most internationalized economies in Latin America, in part because of the relatively strong participation of its SMEs in international trade. The National Industrial Survey (Encuesta Nacional Industrial Anual) carried out by the statistical office Instituto Nacional de Estadísticas on over 4,000 firms in 2010 shows that 22.4 percent of Chilean firms export and 25.3 percent import. Export participation is an especially high 63 percent among companies with 10 percent or more foreign ownership; of domestically owned companies, 19.5 percent export. Especially impressive, Chilean SME exporters derive over 60 percent of their revenues from exports, a level which is high both for domestically and foreign-owned companies (Figure 1).

Some 12.4 percent of Chilean SMEs are two-way traders. The share of two-way traders is particularly high, 35.5 percent, among larger SMEs with 100 or more employees (Table 1). These firms are highly involved in international trade, and are also high-performing, enjoying a significant premia over their non-internationalized peers. Controlling for firm size and industry, two-way traders have 70 percent greater sales and 72 percent more value-added per worker than do firms not engaged in two-way trade (Table 2). Also exporters and importers outdo their non-exporter and non-importer counterparts.

**FIGURE 1/** Export Participation in Chile, by Firm Size



### III. How Diversified Are LAC SME Exporters?

Countries and firms can grow their exports in two ways: along intensive margins (for firms, expansion of existing shipments), or extensive margins (expansion in export markets and products). Table 5 defines the terminology at the different levels of analysis.

There is evidence that countries and firms tend to grow more on the intensive margin than the extensive margin. This again suggests that fixed entry costs play a role in directing SMEs' export decisions. Indeed, if entry costs could be removed, the extensive margin would likely increase significantly.

**TABLE 1/ Types of Chilean Internationalized SMEs**

	All	Small (< 20 employees)	Medium (20–99)	Large (100 and over)
Total number	4,010	1,459	1,818	733
% of all companies that export	22.4%	7.4%	20.3%	57.6%
% of all companies that import	25.3%	10.0%	26.7%	52.1%
% of exporters that import	49.3%	57.6%	88.5%	87.0%
% of non-exporters that import	50.7%	50.0%	59.0%	31.9%
% of importers that export	55.5%	37.0%	53.9%	61.6%
% of non-importers that export	44.4%	63.0%	46.1%	38.0%
% of all companies that export and import	12.4%	2.7%	11.0%	35.5%

**TABLE 2/ Exporter and Importer Premia for Chilean SMEs, 2010**

	Exporter Premia (1)	Importer Premia (2)	Two-way Trader Premia (3)	Exporter Premia (4)	Importer Premia (5)	Two-way Trader Premia (6)
Employment	2.22	1.66	2.19	...	...	...
Sales	4.99	4.00	5.05	0.67	0.79	0.70
Value added per worker	0.81	0.90	0.90	0.67	0.75	0.72
Wages	4.64	3.39	5.36	0.27	0.30	0.30
Control variables	Industry fixed effects	Industry fixed effects	Industry fixed effects	Log employment and industry fixed effects	Log of employment and industry fixed effects	Log of employment and industry fixed effects

Level of Analysis	Extensive Margin	Intensive Margin
Country	Expand number of exporters	Expand existing exporters' shipments
Firm	Expand the number of export markets and products	Expand shipments to existing markets and in existing export products
Product	Expand sales of same product into new markets or a new product in old or new markets	Expand shipments of a product to existing markets

**TABLE 5/  
Defining Intensive  
and Extensive Margin  
at Different Levels**

Sources: Authors on the basis of Instituto Nacional de Estadísticas data.

Seeking growth on the intensive margin makes sense for two reasons. First, deepening existing export relationships is less risky and costly for firms than setting out to market and selling in new markets; the latter strategy will force firms to incur sunk costs related to creating new relationships and accessing new markets, and perhaps force them to adjust their product offering to the new markets. By contrast, the ability of firms to deepen their existing relationships is found to make or break export success, particularly of developing countries, given that failures rates are high for firms expanding into new products and new markets.<sup>12</sup>

The second reason for firms to seek growth on the intensive margin is that deepening existing export relationships can pave the way to new market entries. Recent research on US and German firms suggests that success in a few markets and growth of exports may be a prerequisite for diversifying into new markets and products. Firms that expand their exports substantially in a given market (i.e., expand their intensive margins) are also most likely to be able to expand to third markets and product categories (i.e., expand their extensive margins), as they can leverage the learning and productivity gains scored in the first market or first few markets.<sup>13</sup> In short, growth of the intensive margin helps firms expand their extensive margins.

### **A. *Why Diversify?***

The fact that firms tend to grow their exports by doing more of the same than expanding to third markets or new product does not mean that policy and business attention should focus only on existing exporters and on ways to bolster their existing export relationships. Rather, it means that the challenges of creating new export relationships are different from those involved in expanding the existing ones. In particular, the sunk entry costs in each new market entry are one challenge that restrains diversification. However, export diversification is hugely beneficial for firms, enabling them to spread risk across markets, reduce demand uncertainty, and stabilize export revenues. As such, diversification can increase firms' incentives to invest in new technologies and other productivity improvements.<sup>14</sup>

A recent analysis of Argentine exporters shows that the beneficial outcomes of export diversification are particularly great for smaller firms that are building their foreign customer base. For larger firms whose customer base is already diversified, entering an additional foreign market does not have a large impact on earnings volatility.<sup>15</sup> But for firms starting with one export destination, the authors find that adding a second destination lowers the volatility of

total export sales by almost 2 percent. The additional destination also increases the firms' export premia in the subsequent year as well by raising employment by 25 percent, and productivity by 46 percent.<sup>16</sup> When export markets are defined as regions instead of countries, the export premia are larger: 32 percent for employment and 62 percent for labor productivity. For LAC firms, such regional export diversification often begins in the intra-regional market, then moves to the US and European markets (See Box below).

Export diversification has similar benefits at the country level, where it often enables firms to migrate into higher value-adding activities; this is an important consideration for the many LAC countries whose exports are driven by commodities. In addition, product and market diversification are

### **Export Diversification in Latin America: Using the Intra-Regional Market as a Springboard**

Many firms internationalize by exporting first to nearby markets, where they learn about international sales, and subsequently expand to extra-regional markets.

Eaton et al. (2007) show that for Colombian firms in 1996–2005, exporting typically starts in the intra-regional market, with neighboring LAC markets acting as stepping stones for other Latin American markets. Once firms have successfully penetrated both neighboring and other Latin American destinations, they are more likely to reach larger OECD markets—but not vice versa. Exporters to the intra-regional market have a 24 percent chance to expand further to reach an OECD destination.

While these patterns may well relate to factors such as distance, demand dynamics, and market sizes, they are also telling of the importance of learning-by-doing: experience in increasing productivity gained through exporting to smaller markets sets exporters up for further success.

Such was the route Brazil's Embraer took to become a global aviation giant. The company made its first inroads into export markets in 1975 by selling its Bandeirante and Ipanema aircraft to the Uruguayan Air Force and Ministry of Agriculture, respectively, earning \$5 million in exports.<sup>a</sup> Two years later, the first Bandeirante was sold in an extra-regional market, France, followed within another year by sales to the United States. In 1981—just six years after the initial sale to Uruguay—Embraer won its first large, international procurement bid, selling a batch of 41 Xing airplanes to the French Ministry of Defense. Embraer ultimately invested in production in overseas markets with the 2000 opening of a production facility in Harbin, China.

<sup>a</sup> See Armando Pinheiro, Castelar and Regis Bonelli Bonelli, "Aircraft Industry in Brazil (Embraer)," in *Export Pioneers in Latin America*. 2012. Eds. C. Sabel, E. Fernández-Arias, R. Hausmann, A. Rodríguez-Clare, E. Stein. Washington: IDB.

related. Volpe and Carballo (2008) show that the entry of Peruvian firms into new export markets is directly associated with an expanded number of Peruvian export products.<sup>17</sup> Also related are product diversification and entry of new firms into exporting: new Peruvian export entrants accounted for 26 percent of export products introduced in 2005.

Data from three LAC economies in 2001–08 indicate that SMEs play a hugely important role in export diversification. In 2008, for example, SMEs with fewer than 200 employees in Argentina, Costa Rica, and Peru each exported a total of over a thousand products that were not exported by large firms. Meanwhile, larger firms exported only 195–330 products

**TABLE 6/**  
Number of Products  
Exported by SMEs, Large  
Firms, and Both Types of  
Firms in 2001–2008, by  
Select Economies

Country	Year	SMEs: Num. Emp. < 100			SMEs: Num. Emp. < 200		
		Large Firms	SMEs	Both	Large Firms	SMEs	Both
Argentina	2001	320	964	2,727	211	1,336	2,464
	2002	332	983	2,741	214	1,351	2,491
	2003	312	915	2,780	190	1,323	2,494
	2004	337	864	2,841	217	1,240	2,585
	2005	326	877	2,889	216	1,216	2,660
	2006	327	827	2,914	206	1,199	2,663
	2007	310	785	2,935	193	1,116	2,721
	2008	327	724	2,831	195	1,080	2,607
Costa Rica	2001	324	1,102	1,345	234	1,334	1,203
	2002	330	1,032	1,321	251	1,223	1,209
	2003	366	994	1,382	254	1,263	1,225
	2004	355	1,009	1,441	247	1,281	1,277
	2005	383	914	1,502	281	1,193	1,325
	2006	414	887	1,544	291	1,170	1,384
	2007	427	823	1,558	266	1,132	1,410
	2008	445	808	1,503	324	1,009	1,423
Peru	2001	428	1,068	1,386	303	1,327	1,252
	2002	426	1,106	1,468	309	1,368	1,323
	2003	386	1,150	1,530	261	1,448	1,357
	2004	395	1,197	1,538	296	1,436	1,398
	2005	375	1,169	1,702	288	1,454	1,504
	2006	404	1,133	1,707	313	1,367	1,564
	2007	424	1,050	1,719	313	1,320	1,560
	2008	438	929	1,809	330	1,172	1,674

Sources: IDB/INT based on data from AFIP, SUNAT, CCSS, and PROCOMER.



(depending on the country) not exported by SMEs (Table 6). As regards to products exported by both SMEs and larger firms, SMEs in Argentina exported 3,687 products, SMEs in Costa Rica, 2,432 products, and SMEs in Peru, 2,846 products.

Export product diversification gains produced by SMEs can be significant for LAC countries: Feenstra and Kee (2004) estimate that such diversification accounts for 13 percent of the differences in productivity growth of industries in different countries.<sup>18</sup> A 10 percent increase in export product variety of all industries leads to a 1.3 percent increase in productivity in the analyzed countries.

What is more, new product introductions entail spillovers that other firms can follow. This is especially the case for SMEs. In LAC, SMEs' product introductions tend to be followed by a larger number of firms than new product introductions by larger firms (Table 7). For example, in Argentina,

**TABLE 7/  
Number of Product  
Introductions by SMEs  
Exported By SMEs, Large  
Firms, and Both Types of  
Firms in 2004–2008, by  
Select Economies**

Country	Introduced by:	Number of Products	Average of Followers (prod. w/foll.)
<b>SMEs: Num. Emp. &lt; 100</b>			
Argentina	SMEs Firms	53	2.0
	Large Firms	33	1.4
	Both Firms	5	1.0
Costa Rica	SMEs Firms	257	1.5
	Large Firms	106	1.7
	Both Firms	17	1.4
Peru	SMEs Firms	250	2.0
	Large Firms	102	1.5
	Both Firms	19	3.5
<b>SMEs: Num. Emp. &lt; 200</b>			
Argentina	SMEs Firms	62	2.0
	Large Firms	25	1.3
	Both Firms	4	.
Costa Rica	SMEs Firms	301	1.6
	Large Firms	70	1.2
	Both Firms	9	1.6
Peru	SMEs Firms	276	2.0
	Large Firms	82	1.4
	Both Firms	13	4.1

Sources: Exporter Dynamics Database.

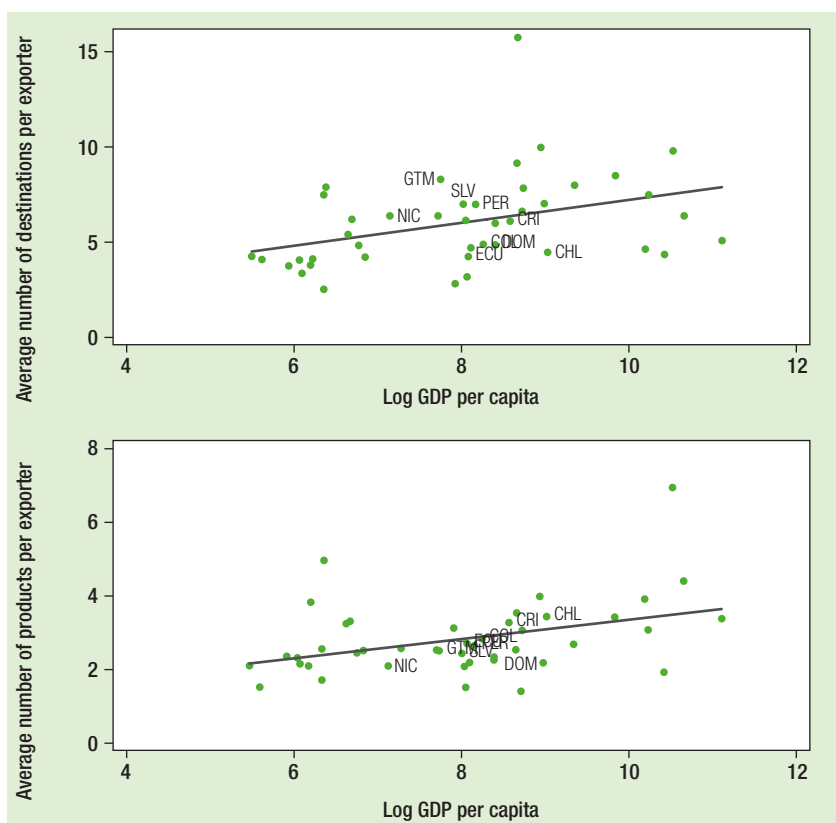
SMEs with fewer than 200 employees introduced in total 62 new products, with each product gaining on average two new followers; the comparable figures for larger firms were 25 products gaining 1.3 followers.

These findings suggest that adding markets and products to the existing exporters' export sales and encouraging the entry of new exporters with new products is an important means to expand trade and productivity among LAC SMEs and economies.<sup>19</sup> But how diversified are LAC exporters?

### B. State of LAC SMEs' Export Diversification

Overall, LAC SME exporters are “narrow” exporters, that is, they export a small number of products to a small number of markets. In LAC countries for which data are available, the average exporter sells 6.1 products (as measured at the 6-digit level of the Harmonized System of tariff classification) to 2.7 markets, based on 2007–09 data. Exporters in more developed economies have a more diversified portfolio in terms of products and destinations (Figure 12).

**FIGURE 12/**  
Correlations of  
Destination and  
Products per Exporter  
with GDP per Capita in  
Select LAC Economies,  
2007–09

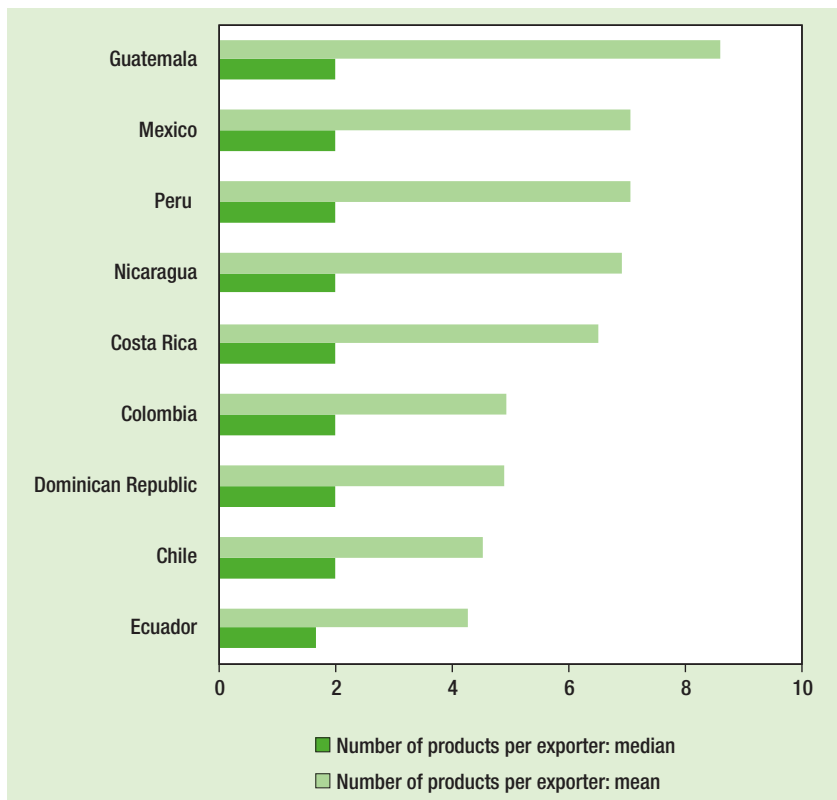


Source: Exporter Dynamics Database.

Measured against countries of equal development levels, LAC exporters export slightly fewer products to fewer destinations, and notably less than such developed markets as Sweden, Norway, and Belgium (9.9 products to 7 destinations). Market and product diversification rates are similar in LAC export sectors; firms in electrical machinery and apparel are somewhat more diversified than firms in other sectors.

These data are skewed by the extreme values corresponding to a few highly diversified, multimarket, multiproduct exporters. The median LAC exporter sells only two products to only one overseas market (Figures 13–14).

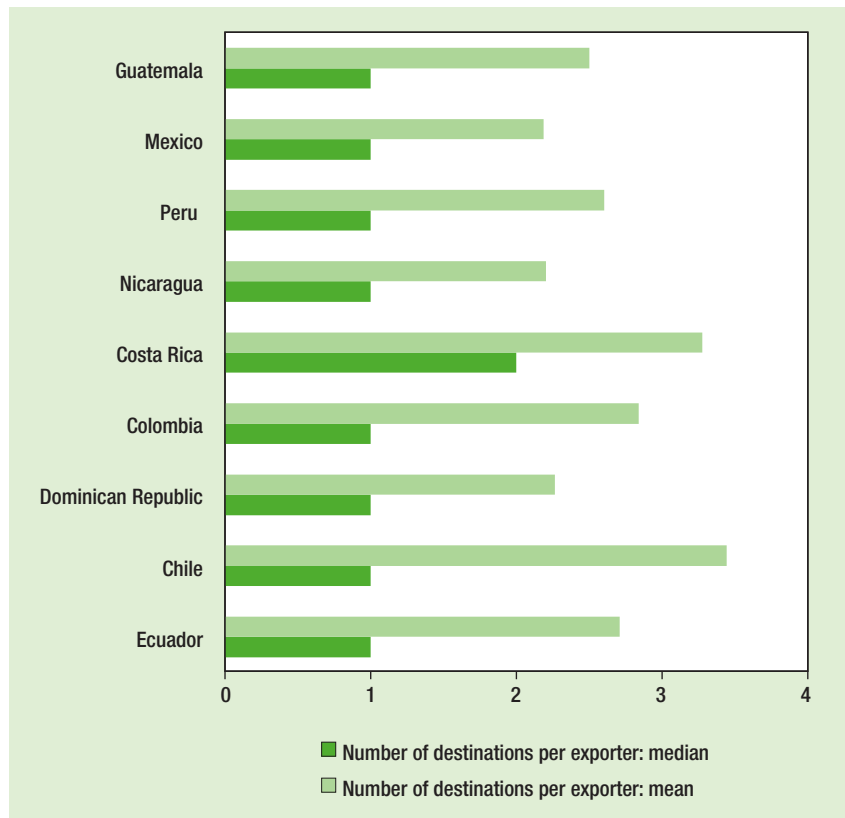
**Stylized Fact 3:** Latin American exporters are still relatively undiversified. The typical LAC exporter exports just two products to only one market; about a third of LAC firms are single-product and single-market exporters that contribute fairly little to regional exports.



**FIGURE 13/**  
LAC Firms' Export  
Product Diversification,  
Average of 2007–09

Source: Exporter Dynamics Database.

**FIGURE 14/**  
LAC Firms' Export  
Market Diversification,  
Average of 2007–09



Source: Exporter Dynamics Database.

**TABLE 8/**  
Share of Single-Product  
Single-Market Exporters  
of All Exporters and  
of All Exports in LAC,  
Average of 2006–08

Country	% of All Exporters	% of Value of Total Exports
Chile	38.5%	0.8%
Colombia	27.5%	3.0%
Costa Rica	33.1%	0.7%
Dominican Republic	37.9%	1.6%
Ecuador	37.5%	4.6%
El Salvador	30.1%	3.6%
Guatemala	27.7%	1.5%
Mexico	40.1%	1.2%
Nicaragua	32.0%	4.2%
Peru	29.8%	3.8%
Mean for 34 countries	34.8%	2.8%
Median for 34 countries	35.4%	2.6%

Source: Exporter Dynamics Database.

A third of LAC exporters export one product to one market. While numerous, these firms collectively make up only less than 5 percent of their respective countries' exports (Table 8). In Mexico, for example, 40 percent of that country's exporters export only one product to only one market, and the total exports of these exporters make up only 1 percent of Mexican exports.

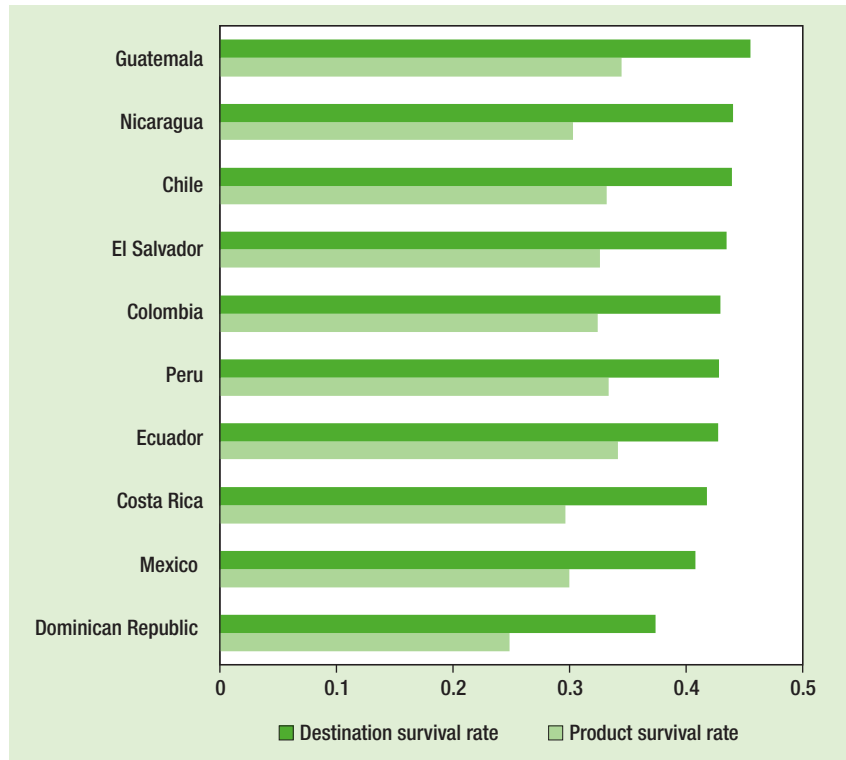
### ***C. Drivers of Export Diversification***

Latin American firms' relatively low level of export diversification is not necessarily a negative thing. After all, it can simply reflect an increase in the number of export entrants in the region, namely, smaller export entrants that typically focus on exporting one product to one market, prior to diversifying further.

The number of exporters has indeed expanded in Latin America and the Caribbean, just as it has in other parts of the world. At the same time, the average entrant in some countries is smaller than in the past. For example, Volpe and Carballo (2008) show that the average number of workers employed by Peruvian exporters dropped from 83 to 72 between 2001 and 2005. This trend is largely explained by the rise of micro firms (firms with fewer than 10 employees) from 62 percent of Peruvian exporters in 2001 to 67 percent in 2005. By initially exporting to just one market, these new entrants keep the average number of destinations low. Although export diversification increased among seasoned exporters, the entry of small players means that the average number of export markets served by the average firm remained steady at 2.6 and that the average number of products per exporter grew only moderately, from 7.5 to 8.15. Overall, the average number of markets served by a one-year-old exporter in 2005 was 1.5 and average number of products, 7.7. In contrast, an exporter with over 20 years of exporting served 3.8 markets with 8.8 products.

LAC region's low levels of export diversification also mask a great deal of ongoing experimentation by exporters on the extensive margin. LAC exporters make frequent forays to new export markets and products. But their frequent failures stunt diversification. In fact, SMEs in LAC are particularly hard-pressed to make the leap from their status as narrow exporters to broad, multimarket and multiproduct exporters. Even among LAC export incumbents (firms that have exported for at least three years), fewer than one-half survive in new markets, and the survival rate for new export products is about 30 percent (Figure 15). This approximates the 70 percent

**FIGURE 15/**  
**Product Survival Rates**  
**Average Destination**  
**and Product Survival**  
**Rates among**  
**Incumbents that Have**  
**Exported for at Least**  
**Three Years or More,**  
**Average of 2007–2009**

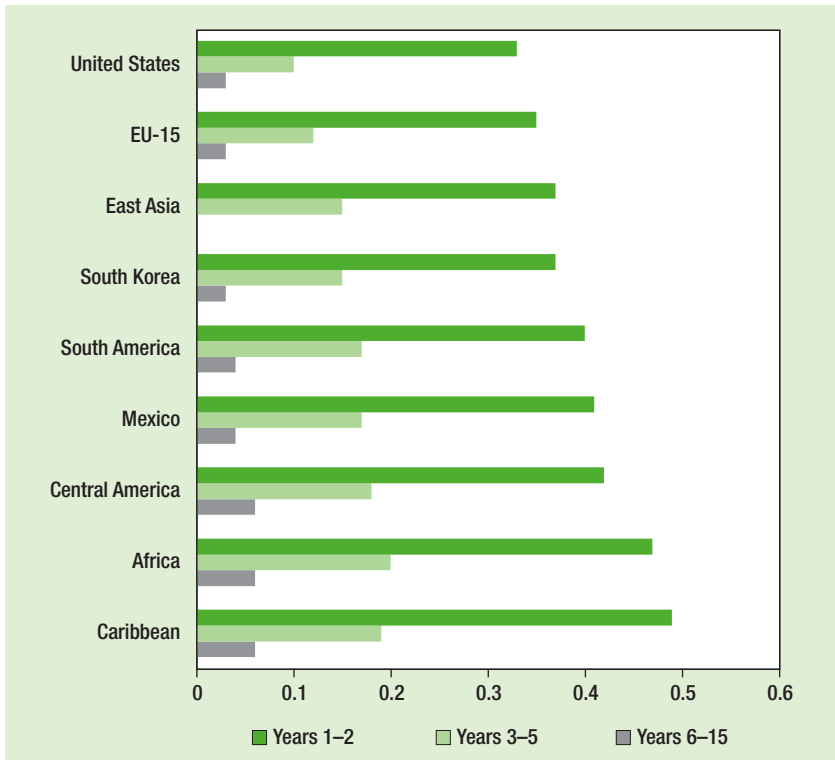


Source: Exporter Dynamics Database.

failure rate of new product launches in developing countries within the first two years of exporting.<sup>20</sup>

Market and product failure rates for LAC exporters are relatively high compared to leading global exporters. Combining market and product diversification by analyzing the survival of entries of a given product in a given market (Besedeš and Prusa 2007) shows that while some 66 percent of US products that were sold to a given market in 1975 continue to be sold in the same market three decades later in 2003, only some 20 percent of Central America's products and a quarter of South America's products continue to be sold in the markets where they were sold in 1975. The likelihood that a product from Latin America will fail in a given export market is some 30–50 percent greater than in the US, especially in the early years (Figure 16).

One explanation for the low rate of market and product survival in LAC exports is the exporters' inability to survive global competition. However, another explanation may be that some exporters export strategically, focusing on their core products while selling marginal products in



**FIGURE 16/**  
Propensity of Failure  
of Product-Market  
Relationships, by  
Country/Region and  
Time Period

Source: Besedeš and Prusa (2007).

low quantities and more sporadically, which would show up in the data as a failure.<sup>21</sup> Similarly, firms may stay in their core markets on a sustained basis, while making forays to peripheral markets, entering and exiting frequently.<sup>22</sup> Or an exporter may have a dry spell, with no orders in the market, such as during recessions or simply in the case of durable goods exports, for which orders are large and lumpy.<sup>23</sup> In addition, the failure rate could indicate that firms are experimenting with new products and markets, which over time can help them learn and ultimately introduce new and successful products and services.

The most likely reason for the lack of product and market survival is that LAC exporters export opportunistically. They export a given product to a certain country only every once in a while, which in the data would show up as lack of survival. Such hit-and-run exporting can be an optimal strategy for smaller, less productive firms, and for firms faced with high entry costs, steep credit constraints, and other obstacles to sustained export participation that we explore in the further chapters.<sup>24</sup>

#### **D. Implications of Limited Export Diversification**

Sporadic exporting is not an optimal strategy for firms or countries seeking to leverage exporting for growth. This is because survival in the new markets and products entails compounding gains. For example, Besedeš and Prusa (2007) find that while South Korea's exporters have had only modestly lower failure rates with their export relationships compared with those of Central American exporters, over 1975–2003, South Korea's slightly superior survival rates translated into 1.5 percentage point higher annual export growth.<sup>25</sup> Had Central America matched South Korea's success, its exports would have been 50 percent larger than they actually were by 2003.

Besedes and Blyde (2010) similarly find that survival rates in LAC equal to that of East Asia would have generated an increase in the annual growth rate of exports of 1.4 percentage points. Over the long 1975–2005 horizon, this higher annual growth rate would have increased exports from 670 percent to around 900 percent, which nearly matches the EU's export growth rate during the same period. The increases in the growth of exports would have been large for Barbados, Honduras, Nicaragua, Panama, and Venezuela, and very significant for Bolivia, Ecuador, El Salvador, Guatemala, Jamaica, Paraguay, Trinidad and Tobago, and Uruguay.<sup>26</sup>

Latin America's relative lack of success in new market and product launches has three further implications. First, high failure rates in the extensive margin increases the importance of the intensive margin in driving export growth. Second, failure rates in new products and markets encourage export concentration in the products and markets that have proven to be successful. Third, the death of a product in an export market does not necessarily mean that the firm dies as an exporter. However, this is likelier in such regions as Latin America, where the typical exporter exports just one or two products.

From the policy perspective, entities such as export promotion agencies play an important role in furthering export diversification, particularly for smaller firms (this issue will be addressed in Chapter 6).<sup>27</sup> Several further policies can foster diversification, such as expanding SMEs' access to credit and lowering the sunk costs involved with new export entries. In addition to providing bundles of services to companies, export promotion policies can also increase spillovers among exporters, an important driver of export diversification. For example, Cadot et al. (2013) find that the probability of success for a new entrant in a new product and market rises with the number of firms exporting the same product from the same country to that same

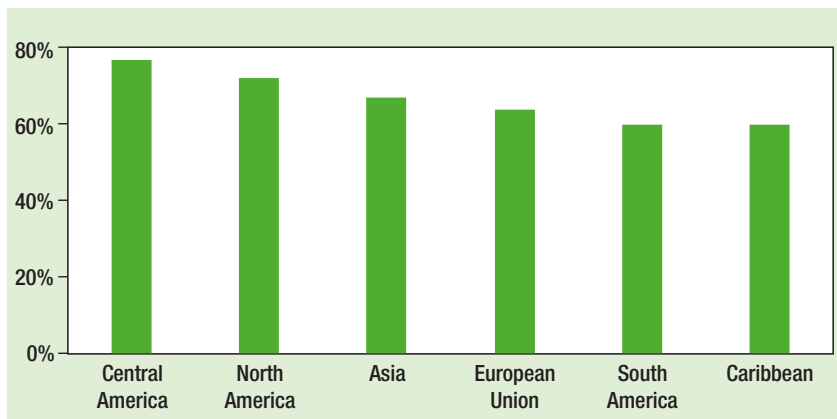


**Stylized Fact 4:** The relatively low export diversification levels of Latin American SMEs are in part due to the growth in the number of small export entrants, which typically initially export only one product to only one market. However and importantly, SMEs are also critical to LAC region's export diversification, and their high failure rates in entering new markets and launching new products may be indicative of experimentation with new products and markets that ultimately leads to successful launches. Nonetheless, LAC firms lag behind their peers in East Asia and advanced markets in maintaining new export relationships, which, in turn, deprives LAC from the compounding gains of exporting.

market. This suggests that export success is fueled by external economies, for instance, when a new exporter obtains information through the network of other exporters of the same product and potential buyers.

#### IV. Export Share and Survival of LAC SMEs

In LAC as in other regions, SME exporters make up the majority of the number of exporters (Figure 17).<sup>28</sup> SMEs also make up a substantial share of LAC trade: about a quarter of the exports of LAC economies are generated by firms with fewer than 200 employees (Table 9).<sup>29</sup> Overall, as is the case in other regions, LAC exports are concentrated in the hands of a few. In terms of volume, over one-half of LAC exports are generated by the top 1 percent of exporters, so-called export superstars. The top 5 percent of exporters generate 80 percent of the region's exports. Moreover, several LAC



**FIGURE 17/**  
Share of SMEs in the  
Number of Exporters,  
by Region

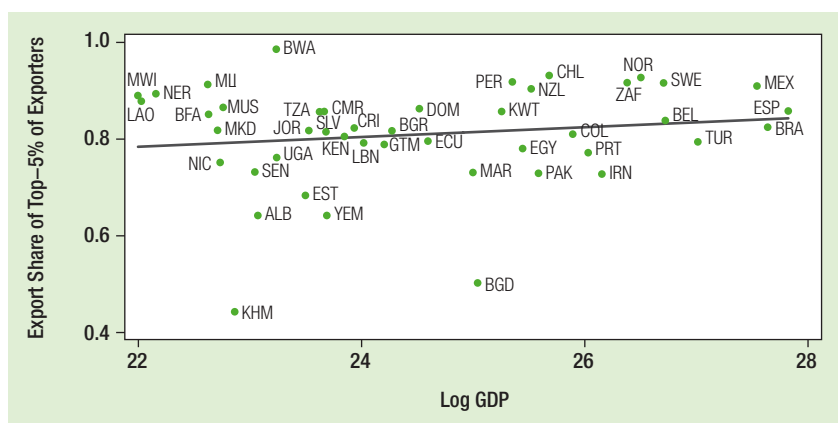
Source: PROCOMER 2013.

**TABLE 9/**  
Share of SME Exports  
of Total Exports,  
Select Economies

Year	Argentina		Costa Rica		Peru	
	< 100 employees	< 200 employees	< 100 employees	< 200 employees	< 100 employees	< 200 employees
2001	21%	30%	24%	32%	23%	28%
2002	18%	27%	22%	29%	22%	28%
2003	15%	25%	21%	29%	21%	26%
2004	16%	24%	26%	36%	21%	25%
2005	16%	24%	21%	30%	20%	24%
2006	14%	23%	23%	30%	17%	21%
2007	15%	23%	18%	28%	19%	22%
2008	14%	23%	18%	26%	22%	26%

Sources: IDB/INT based on data from AFIP, SUNAT, CCSS, and PROCOMER.

**FIGURE 18/**  
Export Share of Top 5%  
of Exporters, Average of  
2007–2009



Source: Exporter Dynamics Database and World Development Indicators.

economies have higher export concentration than economies at comparable levels of development (Figure 18). In terms of sectors, exporter concentration is largest in plastics and base metals (Appendix I).

Intuitively, it would appear that the reason why large firms dominate international trade is entry costs. Each successive product and market entry may have a new fixed cost and require very specific firm assets and capabilities that the largest firms possess more readily than SMEs. Export concentration is typically highest in advanced economies, a pattern that may reflect greater opportunities for economies of scale and scope than in developing countries. For example, in the US, the top 1 percent of exporters accounts for approximately 90 percent of the value of US trade, despite representing only 15 percent of US employment.<sup>30</sup>

The domination of exports by a few and typically longtime exporters disguises a tremendous amount of churn among smaller exporters. During any given time period, a great many firms enter into exporting while others exit. In other words, among the lower rungs of exporters, there is a constant process of experimentation and selection. This churn is highly relevant for countries' export growth, both on the extensive and the intensive margins as entrants bring new products to the country's export basket and the survivors among them can expand overall export sales.

In order to explore these dynamics in Latin America, we use the following definitions:

- Exporter: any firm that exports in year  $t$ .
- Entrant: a firm that does not export in year  $t-1$  but exports in year  $t$ .
- Exiter: a firm that exports in year  $t-1$  but does not export in year  $t$ .
- Incumbent for two years: a firm that exports in both years  $t-1$  and  $t$  or years  $t$  and  $t+1$ .
- Incumbent for three or more years: a firm that exports in years  $t-1$ ,  $t$ , and  $t+1$ .

These different types of firms have very different export profiles. In all countries, incumbents' export volumes dwarf those of entrants. These volumes for the average entrant are typically less than a fifth of those of the incumbent, and export volumes of the median entrant are 16–34 percent those of the median exporter (Table 10). Chilean, Mexican, and Salvadorian entrants and exiters are particularly small in comparison to their exporter peers. The median export volumes of the different types of firms are relatively similar in countries except for Brazil, where the average exporter exports 4–7 times more than exporters in other countries. The average exiter's exports are even lower than those of entrants, suggesting hit-and-run, opportunistic exporting.<sup>31</sup>

### **A. Understanding Entry, Exit, and Survival in LAC**

Three empirical regularities characterize firms' export entry and exit across countries. First, entry and exit rates tend to be lower for developed countries, while survival rates are higher (Figure 19). Latin American countries have far greater exporter churn than such OECD nations as New Zealand or Belgium. At the same time, less developed countries such as Yemen, Malawi, and Tanzania have significantly higher entry and exit rates than LAC countries, 50–60 percent on average. In more developed economies, larger pools

**TABLE 10/**  
Types of LAC Exporters  
(Mean and Median), by  
Export Volumes

	Exporter	Incumbent	Entrant	Exiter	Entrant as % of exporter	Exiter as % of exporter
Brazil	8,923,546	10,900,000	1,851,177	1,171,233	21%	13%
Chile	7,882,809	1,250,000	355,724	252,250	3%	3%
Colombia	1,905,578	2,647,444	228,662	134,884	7%	7%
Costa Rica	3,068,663	3,998,499	370,188	396,231	13%	13%
Dominican Republic	1,578,510	2,849,630	108,582	127,398	8%	8%
Ecuador	1,965,881	3,136,216	303,016	207,495	11%	11%
El Salvador	1,687,027	2,393,492	79,952	92,017	5%	5%
Guatemala	1,474,005	2,224,477	131,020	112,754	8%	8%
Mexico	6,590,016	9,776,325	567,929	419,466	6%	6%
Nicaragua	1,616,846	2,171,410	139,462	112,074	7%	7%
Peru	3,730,911	5,890,732	158,959	119,917	3%	3%

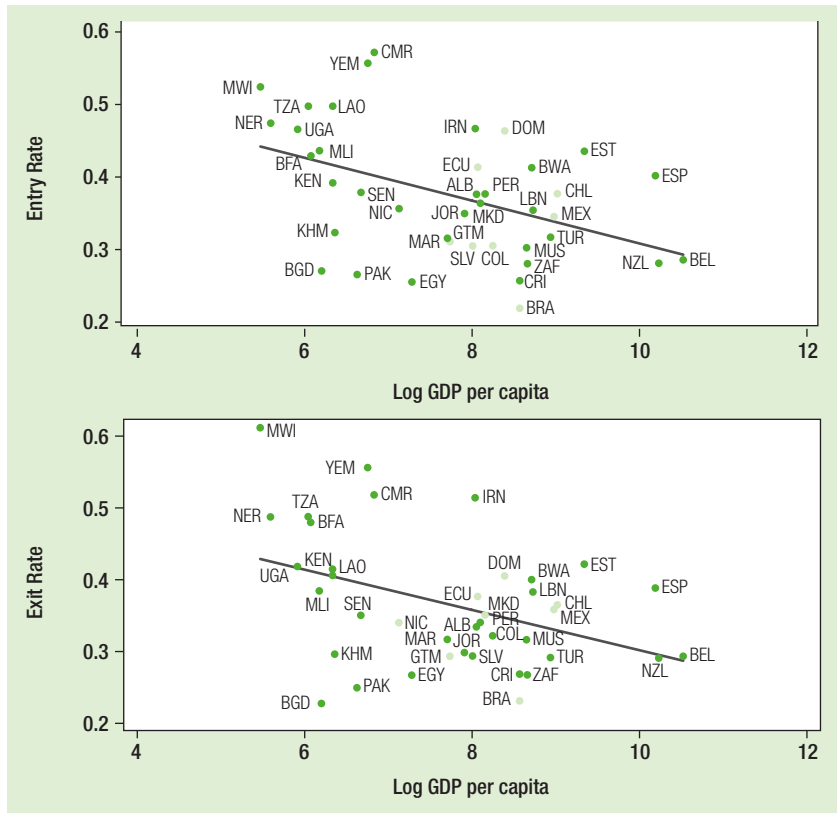
  

	Exporter	Incumbent	Entrant	Exiter	Entrant as % of exporter	Exiter as % of exporter
Brazil	232,993	388,660	40,359	35,478	17%	15%
Chile	50,998	185,702	10,123	8,521	17%	17%
Colombia	59,657	130,871	13,948	10,690	18%	18%
Costa Rica	55,215	119,606	9,000	7,431	13%	13%
Dominican Republic	22,883	90,580	6,459	6,040	26%	26%
Ecuador	30,844	79,226	10,593	6,378	21%	21%
El Salvador	32,015	75,622	7,639	5,823	18%	18%
Guatemala	37,189	93,836	5,811	5,709	15%	15%
Mexico	45,839	116,934	9,968	8,703	19%	19%
Nicaragua	37,189	92,371	6,269	7,642	21%	21%
Peru	40,852	100,288	11,672	7,557	18%	18%

Source: Authors' calculations based on the Exporter Dynamics Database.

of more productive firms may already be operating in the exporting sector; if these firms are well established, their probability of exit is also less. Meanwhile, exporters in less advanced economies may be smaller and less productive and prone to export opportunistically.

Brazil is an outlier with a rather uneventful export sector in which entry and exit rates are low and survival rates are high. This is likely due to a combination of factors, such as the dominance of large commodity producers in the country's export sector and the sheer size of its domestic market. As a result,



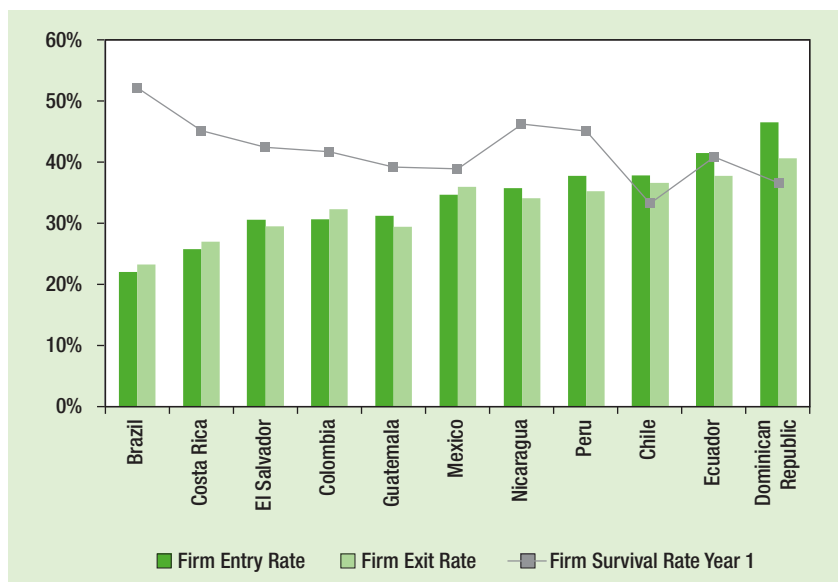
**FIGURE 19/**  
Mean Entry and Exit  
Rates, Average of  
2007–2009

Source: Authors' calculations based on the Exporter Dynamics Database.

most small firms find ample business opportunities at the national level, so fewer enter the export arena. The opposite holds true in the small Caribbean or Central American nations, where exporting is a lifeblood for many firms.

The second regularity in data is that entry and exit rates parallel each other in LAC countries, while churn rates vary across countries (Figure 20). Finally, entry, exit, and survival rates are related to each other and to the size of exporters. Entry and exit rates are strongly positively correlated with each other and negatively correlated with entrant survival rates. Entry and exit rates are inversely related to the size of exporters and entrants, where sectors with smaller exporters tend to see higher churn. This suggests that entry in some sectors requires scale economies or compliance costs beyond the reach of SMEs because small exports in such sectors are unprofitable and result in moderate entry and exit rates. Export transaction-level data across countries analyzed by Freund and Pierola (2010) echo this pattern.<sup>32</sup>

**FIGURE 20/**  
Firm Entry, Exit, and  
Year 1 Survival Rates  
in LAC, Average of  
2007–09



Source: Exporter Dynamics Database.

### **B. Importance of Entrants on Intensive Margins**

There are two reasons why these findings are not negative. First, high entry and exit rates may simply capture experimentation with new products and markets that promote learning and help firms to find the path to ultimate survival.

Second, while entrants' survival rates are low, with fewer than 25 percent of entrants surviving after three years in countries for which data are available (Figure 21), survivors can matter a great deal.<sup>33</sup> In a study of Colombian exporters in 1996–2005, Eaton et al. (2007) find that in a typical year, nearly half of all Colombian exporters are entrants, and that these new exporters tend to be very small compared to incumbents as well as in terms of their overall contribution to export revenues. As in most countries, export sales in Colombia are dominated by a small number of very large and stable exporters.

Even though over two-thirds of Colombian export entrants exit in the first year, those that do stick to exporting make a major difference for the country's exports. The post-1996 entrants account for roughly half of the total expansion in exports over the sample period. The authors suggest that new exporters and their potential buyers undergo a period of learning about one another. As the uncertainties are resolved, exporters either expand their sales substantially or abandon the particular market.



**FIGURE 21/**  
Export Survival Rates in  
Years 1–3, Average of  
2007–09<sup>a</sup>

Source: Exporter Dynamics Database.

<sup>a</sup> Survival rates vary extensively across sectors, tending to be highest in mechanical machinery and transportation vehicles, although there is considerable variation across countries.

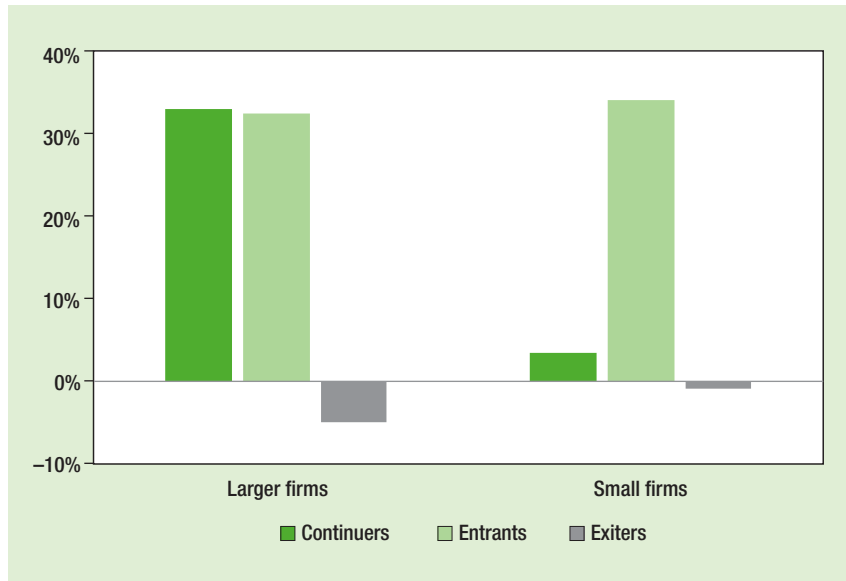
**Stylized Fact 5:** LAC's export profile is greatly skewed in terms of the size of exporting firms' overall contribution. Multiproduct, multi-destination exporters account for a very small share of the number of exporters. At the same time, LAC SMEs account for about a quarter of regional exports and contribute more than do large firms to export product diversification and well as overall export growth.

In a detailed study, Volpe and Graziano (2013) find very similar patterns in Peru. The bottom 99 percent of the number of Peruvian exporters (i.e., all firms but the superstars) accounted for 64 percent of the total export growth (which was 165 percent) between 1994 and 2012.<sup>34</sup> The bottom 90 percent contributed almost 40 percent of the total export growth between 1994 and 2012 (Figure 22). When analyzing only small firms, entrants contributed the bulk of export growth. In short, even if large firms dominate LAC exports, SME exporters are critical for LAC export diversification and overall export growth.

### C. What Drives Entry and Survival?

Firm entry and survival are critical to export growth and diversification. Numerous obstacles could deter a firm from exporting, including uncertainties

**FIGURE 22/**  
**Contribution to the**  
**Growth of Exports in**  
**Peru in 1994–2012, by**  
**Firm Size and Type**



Source: Volpe and Graziano (2013).

related to exporting, high trade costs, or high export entry costs. The strong inverse relationship between churn and the size of exporters suggests that entry rates are higher when entry costs fall. Industries with high entry costs will likely have lower entry rates, while industries with lower entry costs should have higher entry rates.

Drawing on Freund and Pierola (2010), we use exports per incumbent firm as a proxy for export entry costs in an industry, and investigate entry, exit, and survival as the size of entry costs rises.<sup>35</sup> The analysis would ideally be based on transaction-level data; in its absence, we rely on more aggregate annual data. The results nonetheless confirm the findings of Freund and Pierola (2010), who use leverage transaction-level data. Regression results in Table 11 show that a 10 percent increase in entry costs in an industry (as proxied by the size of the average incumbent) results in 0.3 percentage point lower entry and exit rates in the industry and a 0.1 percentage point higher survival rate. Thus, the higher the entry costs, the less likely entry and exit become. To control for the possibility that some sectors or countries have a larger number of firms or higher churn, columns 4–6 include industry and country fixed effects. The results: a 10 percent increase in entry costs results in 0.2 percentage point lower entry and exit rates.

Entry and exit rates are also related to trade costs. In back-of-the-envelope regressions not shown here, entry and exit rates are inversely related



	1	2	3	4	5	6
	Entry	Exit	Survival	Entry	Exit	Survival
Ln(Export value per incumbent)	-0.031*** (0.002)	-0.029*** (0.017)	0.014*** (0.018)	-0.0195*** (0.020)	-0.0172*** (0.024)	0.002 (0.024)
Industry fixed effects	No	No	No	Yes	Yes	Yes
Country fixed effects	No	No	No	Yes	Yes	Yes
Observations	920	920	920	920	920	920

**TABLE 11/**  
Entry Rates Decline  
as Entry Costs Rise

to a country's trade costs, after controlling for firm entry costs and sector-specific factors.

A cursory look at the data on Latin America suggests that export entrants are sensitive to entry costs. On average, entrants' annual exports are 6.6 times larger in industries with above average entry costs than in industries with below average entry costs. To investigate the importance of entry costs in Latin American firms' export behavior, Table 12 includes relative size of entrant (average entrant's annual exports as a share of average exporter's exports) in a country sector. The results suggest that for a given entry cost, entry rates increase with the relative size of entrants. Overall, the results suggest that entry costs critically shape Latin American firms' export behavior. If entry costs are an important driver of entry rates, how might survival among firms that do enter be increased? Survival is driven by the factors that made a firm an exporter in the first place, chief among them, high productivity. Research shows that firms with the highest levels of productivity are likeliest to survive, while the less productive firms are either

	1	2	3	4	5	6
	Entry	Exit	Survival	Entry	Exit	Survival
Ln(Export value per incumbent)	-0.030*** (0.002)	-0.031*** (0.016)	0.016 (0.0018)	-0.026*** (0.002)	-0.027*** (0.002)	0.018*** (0.002)
Ln(Relative size of entrant)				0.054*** (0.014)	0.04*** (0.014)	0.018 (0.016)
Country fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	920	920	920	920	920	920

**TABLE 12/**  
Entry Rates Rise with  
the Relative Size of  
Entrant

**Stylized Fact 6:** LAC SMEs have high export entry and exit rates. This may reflect the entry of smaller firms into exporting and less productive firms engaging in opportunistic, hit-and-run exporting. To be sure, LAC's high exporter churn is positive in that it may indicate that LAC SMEs are engaged in experimentation that can ultimately result in greater export survival. However, entry costs, trade costs, and productivity constraints also hamper Latin American SMEs' export decisions and survival. Public policy can play an important role in the region to alleviate these frictions in the interest of more broad-based and sustained SME exports.

non-exporters or opportunistic exporters that enter and exit. In short, good things go together: higher relative productivity increases the likelihood of exporting, the odds of firm export survival, and also its continued export diversification.

Longtime exporters are also more likely to survive than entrants, and larger firms have better survival prospects than small ones. These more successful firms likely have better access to capital or labor markets, and have superior information about export markets.<sup>36</sup> Exiters, in turn, are often very small and smaller than entrants. A number of studies find that up to one-half of these exiters go out of business after exiting from exporting.<sup>37</sup> To be sure, size does not have to be an obstacle to survival. An example of a firm that internationalized when still small is Uruguay's ARTech featured in Box 3.

These findings provide a basis for policy interventions to further SMEs' export survival. One group of interventions centers on helping SMEs gain access to the same critical assets available to larger firms, such as access to capital and superior labor and information about export markets. Another area is export diversification across markets and products, which is widely found to be key to export survival.<sup>38</sup> Latin America's relatively low survival rates suggest a role for policies to reduce entry costs and other barriers preventing small firms not only from entering the export arena, but from growing into multiproduct, multimarket incumbents.

## V. Conclusion

Seven key findings emerge from this chapter's analysis of the level of dynamics of SME internationalization in the LAC region. They are as follows:

### “Born-global” in Latin America: Uruguay’s ARTech: Successful Small Export Entrant

Globalization and technological advances have altered traditional export patterns. An example is the rise of a new breed of firms that leapfrog the gradual, stepwise path to internationalization. So-called “born-global” companies expand internationally at a fierce rate and within the first years of their inception. These firms turn the conventional conceptualization of internationalization—where success at home is a prerequisite for going global—on its head. Born-globals are overwhelmingly found in high technology and/or high-value-add industries, where their competitive advantage is based on knowledge assets which can earn an adequate return only through these firms’ access to multiple, global markets, and particularly when their home markets are small.<sup>a</sup>

Uruguay’s ARTech exemplifies a born-global company.<sup>b</sup> Founded in 1988 to develop software applications to automate database programming, ARTech served a customer in northern Uruguay before setting out to export to Chile and Brazil, the latter being a natural market for ARTech’s partners given previous experience there. By 1991, ARTech had sold 350 copies of its software GeneXus mostly in the Latin American market and through direct sales abroad. The sales earned it foreign revenue totaling \$250,000. Formation of a partnership with IBM, followed by a close relationship with Microsoft, led ARTech to open overseas offices in Chicago (1994), Mexico (2002), São Paulo (2003), Shanghai (2003), and Tokyo (2007), where ARTech participated in a joint venture with Japanese entrepreneurs for the distribution of its product.

ARTech’s distributor network grew in two decades to encompass 35 countries. The firm now has more than 6,000 customers and has sold more than 50,000 licenses in 60 countries for some \$10 million in addition to \$50 million for related services. Exports made up 90 percent of its total sales by 2007.

ARTech succeeded by combining multiple internationalization pathways into one: early direct sales abroad, establishment of a network of overseas distributors and sales agents, selling through the Internet, and establishing a commercial joint venture. The company also opted for a multilingual product and tailored its product to the different cultures of its foreign markets.

<sup>a</sup> Harris, R. and Q. C. Li. 2006. “Review of the Literature: The Role of International Trade and Investment in Business Growth and Development,” Report to UK Trade and Investment.

<sup>b</sup> See Snoeck, M. and L. Pittaluga. 2012. “Software Discovery in Uruguay: Public-Private Solutions to Co-ordination Failures,” in *Export Pioneers in Latin America*, eds. C. Sabel, Eduardo Fernández-Arias, Ricardo Hausmann, Andrés Rodríguez-Clare, Ernesto Stein. Washington: IADB.

- **LAC SME exporters are critical for LAC countries’ extensive and intensive margins alike.** LAC SME export entrants are critical for introducing new products to their countries’ export baskets, and thus

play a major role in diversifying LAC countries' exports. SME entrants that succeed at sustained exporting contribute very significantly to a country's export growth. For example, one-half of Colombia's export growth over a period of 10 years is attributed to surviving SME entrants. Moreover, SMEs generate positive spillovers: their new export products tend to attract followers—firms from the same country that set out to export that same product.

- **LAC SMEs exporters outperform non-exporters.** Internationalized LAC SMEs are better companies than companies that do not engage in international trade. Both LAC SME exporters and importers employ more workers, pay higher wages, and have higher sales and labor productivity, given equal firm size and other factors. These patterns suggest that international trade plays a central role in LAC SMEs' performance; better companies are more likely to internationalize, and that same internationalization fuels firm performance.
- **Still only a fraction of LAC SMEs export.** LAC SMEs have yet to embrace exporting as a growth lever. Fewer than 15 percent of LAC SMEs export, and those that do derive some 30 percent of their sales from exports. Overall, LAC SMEs trail the export participation of SMEs in comparable economies. There are, however, notable differences across sectors; SMEs tend to participate most in exports of chemicals, electronics, plastic, and textiles.
- **The smallest LAC SMEs are least likely to export and survive in the export game.** Firm size and export participation correlate: smaller SMEs participate much less in exporting than do larger SMEs, and tend to export less than their peers in other economies. Large firms are more likely to export and export more as a share of their overall sales than small firms, as well as to survive in export markets. At the same time, the region's exporters are increasingly smaller and younger, which suggests lowered constraints to exporting.
- **Most SME exporters are undiversified.** The typical LAC exporter exports just two products to only one market, and about a third of the region's firms are single-product and single-market exporters. These firms have little cushion: negative shocks and competitive pressures in one market cannot be compensated by sales to another. As in most other regions, LAC exports are dominated by a few major exporters—typically multiproduct, multimarket multinationals.

- **LAC SMEs have low export survival.** Compared to East Asia and advanced economies, many LAC countries have high export entry and exit rates, as well as low survival rates, particularly among SME exporters. About one-half of all LAC firms that set out to export exit the export market within a year, and most new product launches and market entries fail. Small firms are most likely to fail in exporting. Reasons for this may include the failure of LAC SMEs to prioritize exports as a growth lever, engage in opportunistic exporting as a substitute for sustained exporting requiring higher sunk costs, and/or lack the ability to face foreign competition.
- **Policy interventions should encourage entry and survival.** Encouraging entry is important because firms that survive are a powerful source of export growth and diversification. Entry can be fostered by various export promotion policies and encouragement of spillovers among exporters, while survival can be enhanced through policies that make sustained exporting profitable, as opposed to ad hoc, hit-and-run exporting. One such policy would be improved access to finance.

What do these starting points entail? What are the specific benefits of exporting to LAC SMEs? And what barriers stand in the way to internationalization? The following chapters provide answers.

**APPENDIX I**  
**Summary**  
**Statistics—Firm**  
**Characteristics**  
**by Region**

	Age (years)	Number of employees	% of firms in manufacturing	% of firms in services	% of firms in other sectors	Average size of city	% of domestic ownership in a firm	% of private foreign ownership in a firm	% of government state ownership in a firm	% of a firm held by the largest owner(s)	% of firms with legal status of publicly listed company	% of firms with legal status of privately held Limited Liability Company
East Asia & Pacific	14.2	124.8	64.6	11.7	23.7	Over 1 million	87.5	10.6	0.6	85.3	3.1	21.6
Eastern Europe & Central Asia	13.6	105.3	40.1	32.7	26.4	250,000–1 million	91.4	6.2	1.1	82.7	7.2	57.2
Latin America & Caribbean	20.3	134.3	53.8	16.6	29.5	Over 1 million	89.3	8.9	0.1	75.6	4.4	46.2
Middle East & North Africa	13.0	66.1	51.2	19.1	29.8	Over 1 million	91.3	0.4	0.1	91.7	0.2	1.6
South Asia	15.0	124.6	62.0	13.3	24.7	Over 1 million	97.3	2.2	0.2	84.2	1.5	19.3
Sub-Saharan Africa	13.1	52.4	41.3	21.4	37.2	Over 1 million	81.2	14.7	0.5	86.2	2.5	23.9

Sources: Authors on the basis of Enterprise Surveys.

## Endnotes

- 1 See OECD. 2012. OECD Factbook 2013: Economic, Environmental and Social Statistics. Paris: OECD, 2012. For data, see <http://dx.doi.org/10.1787/888932706869>.
- 2 The following analysis focuses on LAC companies that are in the available data segmented into three categories: small (< 20 employees), medium (20–99 employees) and large (over 100 employees). The available data do not specify an upper bound for the “large” category. However, given that most firms have fewer than 250 employees, we expect that bulk of the “large” firms here will also be SMEs. Note that while the Enterprise Surveys samples are supposedly constructed to be representative of the economies, differences among them in the distribution of several key firm attributes such as ages, location, etc., may at times create cross country differences in relevant export outcomes such as participation rates.
- 3 Because of difficulties in comparing data on regions, this figure excludes Middle East and North Africa.
- 4 In the figure, export intensity is calculated for firms that derive 10 percent or more of their sales from exports.
- 5 Research has been empirically led; among some of the early contributions are the following: for the United States, Bernard, A. B. and J. Bradford Jensen. 1999. “Exceptional exporter performance: Cause, effect, or both?,” *Journal of International Economics*, vol. 47(1): 1–25, February; for Germany, Bernard, A. B. and J. Wagner. 1997. “Exports and Success in German Manufacturing.” *Weltwirtschaftliches Archiv / Review of World Economics*, 133 (1): 134–157; and for Colombia, Mexico, and Morocco, Clerides, S. K., S. Lach, J. R. Tybout. 1998. “Is Learning by Exporting Important? Micro-Dynamic Evidence from Colombia, Mexico, and Morocco,” *The Quarterly Journal of Economics*, vol. 113(3): 903–947, August. Following these studies, countless others were produced around the world.
- 6 See, for example, Roberts, M. and J. R. Tybout. 1997. “The Decision to Export in Colombia: An Empirical Model of Entry with Sunk Costs,” *American Economic Review*, vol. 87, no. 4. (September); Bernard, A. and J. Bradford Jensen. 2004. “Why Some Firms Export.” *Review of Economics and Statistics* 86, 561–569; Görg, H., M. Henry and E. Strobl. 2008. “Grant Support and Exporting activity,” *Review of Economics and Statistics*, 90: 168–174; and Barrios, S. and H. Görg, and E. Strobl. 2003. “Explaining Firms’ Export Behaviour: R&D, Spillovers and the Destination Market,” *Oxford Bulletin of Economics and Statistics*, vol. 65: 475–496 (September).
- 7 See Melitz, M. J. 2003. “The Impact of Trade on Intra-Industry Reallocations and Aggregate Industry Productivity,” *Econometrica* 71 (6): 1695–1725 (November).
- 8 To be sure, exporter heterogeneity is not the only factor that plays a role in the odds of exporting and the gains from exporting. More recently, analysts have found comparable variation in size and performance across importers. For example, Bernard et al. (2013a) find that “buyer-side heterogeneity plays an important role in generating the variation of exports across sellers and in explaining the response of exports to aggregate shocks.” See Bernard, A. B., A. Moxnes, and K.

- H. Ulltveit-Moe. 2013. “Two-Sided Heterogeneity and Trade,” CEPR Discussion Paper 9681 (September). See also Carballo, J., G. Ottaviano and C. Volpe Martincus. 2013. “The Buyer Margins of Firms’ Exports,” CEPR Discussion Paper 9584 (August). They use highly disaggregated firm-level export data from Costa Rica, Ecuador, and Uruguay in 2005–2008 to detail firms’ export margins, across products, destination countries, and customers, and show that a firm’s number of buyers and the distribution of sales across them systematically vary with the characteristics of its destination markets. While most firms serve only very few buyers abroad, the number of buyers and the skewed sales across them increases with the size and the accessibility of destinations. In their model, tougher competition induces a better alignment between consumers’ ideal variants and firms’ core competencies. This generates an additional channel through which tougher competition leads to higher productivity and higher welfare and hints at an additional source of gains from trade as long as freer trade fosters competition.
- 9 See, for example, Vogel, A. and J. Wagner. 2012. “The Impact of R&D Activities on Exports of German Business Services Enterprises: First evidence from a continuous treatment approach,” Working Paper Series in Economics and Institutions of Innovation 293, Royal Institute of Technology, CESIS—Centre of Excellence for Science and Innovation Studies.
  - 10 Alborno, F., H.F. Calvo Pardo, G. Corcos, E. Ornelas. 2012. “Sequential exporting,” *Journal of International Economics* vol. 88(1):17–31; and Rauch, J. E. and J. Watson. 2003. “Starting small in an unfamiliar environment,” *International Journal of Industrial Organization*, vol. 21(7): 1021–1042 (September).
  - 11 Conconi, P., A. Sapir, and M. Zanardi. 2013. “The Internationalization Process of Firms: from Exports to FDI,” CEPR Discussion Papers 9332.
  - 12 Besedeš, T. and T. J. Prusa. 2007. “The Role of Extensive and Intensive Margins and Export Growth.” NBER Working Paper 13628 (November).
  - 13 See, for example, Wagner, J. 2012. “German multiple-product, multiple-destination exporters: Bernard-Redding-Schott under test,” University of Lüneburg Working Paper Series in Economics no. 242 (June).
  - 14 Discussed in Chapter 2, reduction of trade costs and barriers to trade can also incentivize exporters to adopt better technologies. See Lileeva, A. and D. Trefler. 2010. “Improved Access to Foreign Markets Raises Plant-Level Productivity... for Some Plants,” *The Quarterly Journal of Economics*, vol. 125(3): 1051–1099 (August.); and Bustos, P. 2011. “Trade Liberalization, Exports, and Technology Upgrading: Evidence on the Impact of MERCOSUR on Argentinian Firms,” *American Economic Review*, 101(1): 304–40. See also Buch, C., J. Döpke, and H. Strotmann. 2009. “Does Export Openness Increase Firm-Level Output Volatility?” *World Economy* 32 (4): 531–51.
  - 15 Juvenal, L. and P. Santos Monteiro. 2013. “Export market diversification and productivity improvements: theory and evidence from Argentinean firms,” Working Paper 2013–015, Federal Reserve Bank of St. Louis.
  - 16 These benefits are somewhat less when the firm expands to further markets. In terms of reducing earnings volatility, there appear to be diminishing returns from each additional market, even though aggregate earnings will increase with new markets.



- 17 Volpe Martincus, C. and J. Carballo. 2008. "Is export promotion effective in developing countries? Firm-level evidence on the intensive and extensive margins of exports." *Journal of International Economics* 76, 1.
- 18 Feenstra, R. and H. L. Kee. 2004. "On the measurement of product variety in trade," Policy Research Working Paper Series 3213, Washington, DC: World Bank.
- 19 However, multiproduct exporters do not ship all goods equally across markets. A study on Brazilian firms finds that in each market a small number of products typically accounts for a bulk of the firm's sales, and these products are also more likely to be shipped to other destinations. At the other end, the lowest-selling products are sold in small amounts, sometimes for negligible amounts—even less than the lowest-selling products of small exporters.
- 20 Besedeš, T. and T. J. Prusa. 2007. "The Role of Extensive and Intensive Margins and Export Growth." NBER Working Paper 13628 (November).
- 21 On focus on core exports, see Arkolakis, C. and M.-A. Muendler. 2011. "The Extensive Margin of Exporting Products: A Firm-Level Analysis." NBER Working Paper no. 16641 (August).
- 22 See, for example for Swedish exporters, Gullstrand, J. and M. Persson. 2013. "How to Combine High Sunk Costs of Exporting and Low Export Survival." IFN (Research Institute of Industrial Economics, Sweden) Working Paper no. 962.
- 23 Brenton, P., O. Cadot, and M. Denisse Pierola. 2012. *Pathways to African Export Sustainability*. Washington, DC: World Bank.
- 24 Békés, G. and B. Muraközy. 2012. "Temporary trade and heterogeneous firms." *Journal of International Economics* 87:232–246.
- 25 Besedeš, T. and T. J. Prusa. 2007. "The Role of Extensive and Intensive Margins and Export Growth." NBER Working Paper 13628 (November).
- 26 Studying African and Colombia export spells, respectively, Cadot et al. (2013) and Eaton et al. (2008) find that export spells do survive further export growth. See Olivier Cadot, Leonardo Iacovone, Martha Denisse Pierola, and Ferdinand Rauch. 2013. "Success and Failure of African exporters," *Journal of Development Economics* 101: 284–296.
- 27 For an analysis of impact of export promotion by firm size, Volpe Martincus, C., J. Carballo, and P. M. García. 2010. "Public Programs to Promote Firms' Exports in Developing Countries: Are There Heterogeneous Effects by Size Categories?" IDB Working Paper (August).
- 28 See Calderón, J.C., E. Céspedes, M. Chacón, K. López, C. Medaglia, E. Mora, F. Vargas, J. M. Vargas, L. C. Vargas. 2013. *Estadísticas del Comercio Exterior Costa Rica, 2012*. San José: Promotora del Comercio Exterior de Costa Rica.
- 29 For an analysis of the contributions of Colombian SME exporters, see Meléndez, M., "Internacionalización de las PYMES en Colombia," *Integración y Comercio* 37, 17 (Julio-Diciembre):25–40. For Guatemalan exporters, see Coyoy Echeverría, E. and G. Díaz. 2013. "Estimación del aporte de la PYME a las exportaciones de Guatemala," *Integración y Comercio* 37, 17 (Julio-Diciembre):103–111.
- 30 Bernard, A., B. J. Bradford Jensen, S. J. Redding, P. K. Schott. 2012. "The Empirics of Firm Heterogeneity and International Trade," *Annual Review of Economics* vol. 4(1): 283–313.

- 31 First year entrants' export values need to be taken with a grain of salt. In a study by Bernard et al. (2013) on Peruvian exporters, the authors find that "Two otherwise identical firms that enter the same market in different months, one in January and one in December, will report dramatically different annual sales for the first calendar year of operations. This partial year effect in annual data leads to downward biased observations of the level of activity upon entry and upward biased growth rates between the year of entry and the following year. This paper examines the implications of partial year effects using Peruvian export data. The partial year bias is very large: the average level of first-year exports of new exporters is understated by 65 percent and average growth rate between the first and second year of exporting is overstated by 112 percentage points." Bernard, A. B., R. Massari, J.-D. Reyes, and D. Taglioni. 2013. "Exporter Dynamics, Firm Size and Growth, and Partial Year Effect." World Bank Policy Research Working Paper 6711 (November).
- 32 Freund, C. and M. D. Pierola. 2010. "Global Patterns in Exporter Entry and Exit," Preliminary Draft. World Bank.
- 33 Volpe Martincus, C. and A. Graziano, "Firms and Trade: Not So Simple," Presentation, IDB Workshop on Internationalization of SMEs, Washington, DC, September 30, 2013.
- 34 For countries for which data are unavailable for 2007–09, the latest available year is used—typically, 2006.
- 35 See Freund, C. and M. D. Pierola. 2010. "Global Patterns in Exporter Entry and Exit," Preliminary Draft. World Bank. The authors use incumbent size because when entry is high there may be many single-transaction entrants, which drives down annual exports and potentially create a reverse causality problem. Thus, average annual exports—or similarly average entrant exports—may be negatively correlated with entry rates simply because industries with a large share of entrants have, by construction, more weight on the entrants with small annual exports. Roberts and Tybout (1997) and Bernard and Jensen (1999) similarly use lagged export status as a proxy for sunk entry costs and find that they play a significant role in the decision to export. See Roberts, M. and J. R. Tybout. 1997. "The Decision to Export in Colombia: An Empirical Model of Entry with Sunk Costs," *American Economic Review* vol. 87, no. 4. (September); and Bernard, A. B. and J. Bradford Jensen. 1999. "Exceptional exporter performance: cause, effect, or both?," *Journal of International Economics*, vol. 47, no. 1: 1–25.
- 36 For a discussion, see Volpe and Carballo 2008. "Survival of New Exporters in Developing Countries: Does It Matter How They Diversify?" *Universai* vol 2, no. 3. Also see Esteve Pérez, S., A. Sanchis Llopis, and J. Sanchis Llopis. 2004. "The determinants of survival of Spanish manufacturing firms." *Review of Industrial Organization* vol. 25 no. 3 (August): 251–273.
- 37 See Sanne Hiller, Philipp J.H. Schröder, and Allan Sørensen. 2013. Export market exit and firm survival: Theory and first evidence." University of Lüneburg Working Paper Series in Economics no. 262 (January).
- 38 See, for example, Volpe and Carballo 2008. "Survival of New Exporters in Developing Countries: Does It Matter How They Diversify?" *Universai* vol 2, no. 3.

The previous chapter showed that LAC SMEs have relatively low export participation and intensity, limited export diversification, and low export survival rates. Nevertheless, SME exporters play an important role in their national economies. LAC SME export entrants are critical for introducing new products to their countries' export baskets, and thus play a critical major role in export diversification. In addition, SME entrants that succeed at sustained exporting contribute very significantly to a country's export growth. SMEs also generate spillovers. For example, their new export products tend to inspire other firms from the same country to export that same product.

We have also shown that exporters enjoy premia over non-exporters: they are larger, more productive, and more skill-intensive than are non-exporters. Does this mean that exporting unequivocally benefits firms? Or do better firms simply self-select into exporting? And do incumbents perform better than recent entrants? More broadly, from the policy perspective, what would be the benefits from enhancing LAC SME internationalization, both to individual firms and to the region's trade, growth, and development?

This chapter will answer these questions. Drawing on leading studies from Latin America as well as various advanced and developing markets around the world, we identify specific and significant benefits ranging from exporting to firm performance. These gains vary by firms' internal capacities as well their survival in export markets, export diversification, development levels in the firms' home markets, and the trade policy environment in which firms must operate.

Data constraints hamper existing analyses from distinguishing between the exporting impact of large firms and SMEs. However, studies focused on SMEs tend to find equal if not larger gains from exporting than do the general analyses. Research findings are thus useful for Latin American countries seeking to foster growth, employment, and development through SME internationalization.

Internationalization of LAC firms produces important economic benefits in exports and export diversification. Exporters tend to raise all boats in their home markets. They typically employ more people than do non-exporters, and they also generate positive spillovers, such as job creation in

the many firms they rely on for inputs, products, and services. Exporters can also impart valuable knowledge and skills gained through exporting to non-exporters. And by increasing their productivity through exporting, exporters reap greater market shares at home, making the entire economy more productive.

SME exporters can produce particularly important benefits. Exporting is a powerful growth accelerator that can transform SMEs into large firms that offer employment to tens of thousands. In addition, exporting can give SMEs fresh resources to invest in innovation, a key driver of economic growth that is sorely needed in Latin America. And given that SMEs are the backbone of LAC economies and the source of employment to millions of people, their export activities have the potential to improve the lives of the region's majorities.

Part one of this chapter synthesizes research findings on the impact of exporting on firm performance. Part two analyzes the effects of exporting by other means, specifically the integration of SMEs into global value chains. The third part probes deeper into the broader economic significance of SME internationalization. Part four summarizes the main findings.

## **I. Exports and Firm Performance: What Is the Link?**

Extensive academic research in countries around the world shows that firms that export typically outperform non-exporters in productivity, wages, and job creation.<sup>1</sup> Exporters are also more resilient and tend to outrank non-exporters in revenue growth.<sup>2</sup> Chapter 1 showed this also to be the case in the LAC region: SME exporters have 55 percent higher sales, 54 percent higher labor productivity, and they pay 42 percent higher wages than non-exporters.

Is it safe to conclude that exporting benefits firms? Research in several countries and time periods shows that good companies self-select into exporting; higher-performing firms that tend to embrace international markets and become exporters. This robust finding implies that exporters are not necessarily better firms because they export, but because they are better to begin with. This finding speaks to the issues discussed in Chapter 1: since exporting has high sunk entry costs, only the most productive firms are able to export.

This said, it is also true that the very act of exporting has an independent effect on firm performance. When compared to non-exporters,

exporters gain higher revenue and productivity growth as a result of their export drive. Consider five specific ways this might occur:

- **Learning-by-exporting:** Exporters gain information from their international buyers, distributors, and competitors, which leads to the discovery of new market opportunities and improved management decision making.<sup>3</sup>
- **Innovation:** Exporting can increase firms' propensity to innovate and invest in R&D to improve products and processes that meet customer demands and respond to competitive pressures.<sup>4</sup>
- **Revenue diversification:** Revenue diversification in different international markets often reduces the volatility of the firm's sales along with vulnerability to downturns in any one market.
- **Capacity utilization:** In firms and industries with opportunities for scale economies, selling in international markets increases capacity utilization and reduces average costs.
- **Competitiveness:** Exporters are generally exposed to intense foreign competition, which forces them to pursue the greater efficiencies needed to survive in foreign markets.

More generally, exporters are motivated to upgrade their technologies, improve distribution channels, or enhance the composition of their labor force to strengthen their competitiveness, increase market penetration, conquer new markets, and introduce new products.

Moreover, exporting by some firms can have positive spillovers to other firms within the same sector as well as firms in up—and downstream industries. The spillover effect has important potential impacts for the domestic market, including on labor markets. Granted, productivity spurts associated with exporting may result in the firm doing more with the same, i.e., using the same amount of staff and facilities to produce for the export markets. Or the productivity spurt may be unassociated with job gains. However, it is also plausible that firms that grow larger as a result of exporting, in which case they will generate new jobs, hire more skilled labor, and pay higher wages, than non-exporters. In a recent example, exports were found to add 18 percent to workers' earnings in US manufacturing firms, even after controlling for the workers' educational attainment.<sup>5</sup>

How significant are these gains from exporting? And which firms reap the greatest gains? The following sections will seek to provide answers.

### ***A. What Impact from Exporting on Firms? Methodology Matters***

Academic research has long been inconclusive on the impact of exporting on firm productivity. Several studies supported the notion that exporting translates into productivity gains. In a study of German exporters, Bernard and Wagner (1997) found that the labor productivity of export starters is 4.8–6.7 percent greater than for non-exporters in the year after exporting starts.<sup>6</sup> A 2001 study of Colombian firms found that exporters' labor productivity grows 1.5 percent faster annually in the five years following export entry than for non-exporters.<sup>7</sup> Regardless of methods and data sources, studies on Italian, British, Canadian, Chinese, and Sub-Saharan African firms all yielded similar results.<sup>8</sup>

However, further studies authored in the late 1990s and early 2000s, which looked at Chilean firms in 1990–96, Mexican, Colombian, and Moroccan firms in the 1990s, and Mexican firms in 1986–90, found no meaningful differences between exporters and non-exporters in labor productivity or total factor productivity following export entry.<sup>9</sup> In a classic study on US firms, Bernard and Jensen (1999) showed that employment growth and the probability of firm survival are both higher for existing exporters than for non-exporters, but that productivity and wage growth are not superior for exporters.<sup>10</sup> In other words, this seminal research supported the self-selection hypothesis, but not the learning-by-exporting hypothesis.

There have also been discrepancies between case studies that present generally strong micro-level evidence for export-led productivity growth within firms or plants, and econometric studies that have struggled to detect such a productivity gain. For example, in a detailed survey of 112 Korean exporters, Rhee, Ross-Larson, and Pursell (1984) found that 40 of them reported to have learned from buyers through personal interactions, knowledge transfer, or product specifications and quality control.

These conflicting findings do not mean that exporting does not spur productivity growth. Rather, the impact of exporting on firms has been underestimated by various methodological choices. One such choice is the focus on productivity as the dependent variable, which is typically the difference between total sales and quantifiable inputs, such as labor and capital. The gains scored by exporters might better be measured as marginal cost that is unaffected by prices. A recent study on Chilean firms finds that marginal costs drop 15–25 percent on average when firms begin to export.<sup>11</sup> However, prices drop by the same order of magnitude while volume grows, indicating that exporters initially charge lower prices and sell more. As such,

studies analyzing the impact of exporting on productivity tend to underestimate efficiency gains from exporting.

The second methodological choice is the rather simplistic independent variable that divides firms into exporters and non-exporters when both categories are diverse. Indeed, exporters differ from one another in the following ways:

- **Export intensity.** It is unlikely that firms with a handful of small export shipments per year would experience similar gains from exporting as firms for which exports constitute a much larger percentage of sales.
- **Duration in the export market.** Chapter 1 showed that most export entrants exit after a year or two of exporting. Their gains are unlikely to be as large as those of firms that export for years. Higher survival rates are closely associated with higher productivity.
- **Export diversification.** Firms can expand exports in different ways. Some seek to increase sales by focusing on serving existing customers in existing markets. Others choose to diversify to attract new customers with new products, even in new markets. Research indicates that diversification is risky, but it can also be a productivity booster when done right.
- **Exporters' home market.** Exporters in developed markets tend to be closer to the technological frontier than firms in developing countries; this may imply that developing country exporters achieve greater innovation gains from exporting.
- **Firm's export market.** Policy changes and other shocks in the firm's export market can critically shape gains from exporting. For example, firms exporting to countries engaging in extensive trade liberalization should achieve greater export gains than firms exporting to more protected markets.

In short, understanding the specific impacts of exporting on firm performance requires a finer contrast between different kinds of exporters. The following sections deepen our understanding of the benefits of exporting in light of these distinctions.

### **B. Importance of Export Intensity and Survival**

Export-intensive firms generally outperform firms with low export intensity.<sup>12</sup> However, the apparent gains from increasing export intensity are not necessarily linear. A 2007 study on German manufacturing firms finds that



exporting starts improving labor productivity growth when the firm's exports-to-sales ratio rises to 20–50 percent. However, when exports grow to make up more than one-half of the firm's overall sales, they boost firm productivity less than at the export intensity of 20–50 percent.<sup>13</sup> In other words, there appears to be an inverted U-shaped relationship between export intensity and firm productivity, in which firms with very low and very high export intensities fail to experience progressively greater gains.

There are similar nonlinearities over time between export entry and subsequent years of exporting. For example, some studies argue that exporting has diminishing returns over time: firm productivity rises noticeably when the firm starts exporting, but less significantly, if at all, after entry. Several studies, including on UK and French manufacturing firms, show that the impact of exporting on productivity is higher in the first year but increases only modestly in the following year.<sup>14</sup> Still other studies examining the relationship between exports and firm performance over time have found U-shaped and S-shaped patterns, typically over the span of 3–5 years.<sup>15</sup>

What explains these various patterns? Is there an optimal export intensity? And do the benefits of exporting wax and wane over time?

The simplest answer could be that the effects of learning-by-doing decrease over time. Firms may learn a great deal when they first start exporting, but less in the years that follow. Another answer is that the initial productivity boosts result from a scale effect whereby the firm takes advantage of a larger market to place its additional output. In other words, the productivity surge only reflects the firm's use of spare capacity in the new markets.

There are three further explanations for these patterns. The first is that firms with higher export intensities might also sell to a larger number of export destinations, and that each successive entry implies new sunk costs that may be compensated for by future—and not present—profits. In other words, there is a temporal disconnect between the benefits of exporting and its costs whereby sunk entry costs weigh negatively, albeit temporarily, on firm performance in the first few years after export entry.<sup>16</sup>

The second possible reason for the nonlinearity between exporting and productivity is that under certain circumstances, high levels of exporting can be associated with high control and coordination costs. Growing geographic distance to market, differences in tastes and cultures, an expanding export product portfolio, and differences between the firm's export markets all raise the costs of exporting and require the firm to hire additional personnel. In such cases, which may affect different firms at different times in



their internationalization process, increasing international expansion can affect a firm's productivity growth.<sup>17</sup>

Third and most likely, it may simply take a long time for firms to learn to export successfully. The real productivity gains from exporting kick in only years later, which is beyond the timeframe of the typical analyst. Indeed, some empirical studies find multiple waves in the relationship between firms' level of foreign involvement and their performance.<sup>18</sup> This indicates that exporting is not a linear but an iterative process of several phases of learning-by-doing. Along the way, many firms drop out. A study of Finnish firms concluded that approximately 25 percent of plants that start exporting exit after just the first year, but that the dropout rates shrink after the first five years of exporting. In other words, firms surviving through year five in the export market have a high probability of surviving in the subsequent years. The authors call these first five years the most critical period for new exporters.<sup>19</sup>

These findings indicate that when compared with future exiters, future export incumbents are far better able to establish profitability in overseas markets. As a result they start enjoying a virtuous cycle of productivity gains that drives additional international expansion and fuels profits and further productivity. Conversely, exiters are generally found to have far worse productivity growth rates than incumbents, and even worse than non-exporters, according to some studies. This finding may indicate these firms were relatively nonproductive to begin with, exporting only in response to occasional overseas demand, and/or that they experienced highly negative shocks during the time they exported.<sup>20</sup>

It could thus also be expected that the firms experiencing greater productivity gains end up serving more markets and exporting a wider range of products. In contrast, the exporters reaping less productivity increases do not enter new markets or product categories to begin with. Is this the case? Do multiproduct exporters outperform?

### **C. Multiproduct, Multimarket Exporters—Different Effects, Different Pathways?**

As discussed in Chapter 1, multiproduct exporters dominate global trade flows. They are also typically larger and more productive than firms that export to only one market. They are also more seasoned: companies that have exported for a year or more have a higher average number of product varieties and export markets than do entrants.<sup>21</sup>

There are two reasons why these broad exporters have higher productivity than narrow exporters.

The first is selection. Exporting multiple products to multiple markets may imply higher coordination costs for the firm, so that only the more successful and productive exporters are able to expand further. Research on US and German companies find that the number of products exported and the number of export destinations are significantly related to a firm's total exports, exports of the firm's largest product in all markets, and firm productivity.<sup>22</sup> Granted, productivity can also grow as a result of export diversification: a study on Chilean exporters in 1995–2005 suggests that changes in the export mix—particularly adding products—has a robust positive impact on SMEs' productivity.<sup>23</sup>

Firms that diversify tend to have grown their initial export markets and leveraged their core products. In other words, growth on the intensive margin (selling more to existing customers) appears to be critical for growth on the extensive margin (selling new products to new markets). Productivity gains from expanding on existing relationships enable firms to enter new markets with existing products and make profits by exporting new, previously marginal products.

A second reason why broad exporters have higher productivity than narrow exporters is to overcome the risk entailed by export diversification. Chapter 1 showed that while most new product and market launches fail, multiproduct and multimarket exporters that do succeed in their new launches score new gains. Export diversification insulates firms against demand shocks in any given market and stabilizes export revenue. In contrast, the probability of exit increases significantly following a sudden loss of market share, which is all too possible when the firm exports to only one or two markets.<sup>24</sup> Multiple studies have found that market and product diversification enhance firm export survival.<sup>25</sup>

It is of course possible for a firm to expand to various markets simultaneously. But this strategy is costly and risky for small companies with limited resources for covering fixed costs of export entry and limited capabilities for planning and managing marketing, sales, and relationships in different markets. These constraints also mean that multiproduct, multimarket exporting takes time, and survival and scaling up in the existing markets logically follow. The case of Brazil's SADIA, which entered international markets by selling pork and subsequently diversified into new products, is illustrative (See Box below).

### Diversifying Exports, Gaining Productivity: Brazil's SADIA

Brazil's SADIA increased its productivity through an export-led strategy combined with market and product diversification to become one of Brazil's ten largest exporters. The pork producer started selling to the European Common Market and Switzerland in the 1960s. It then diversified by exporting poultry to several Middle Eastern markets such as Kuwait, Saudi Arabia, United Arab Emirates, and Qatar, followed by beef and pork sales to Spain, France, Italy, and Portugal. In the 1970s, the company diversified its export basket and began to export beef to Europe, the United States, and, together with poultry, to Middle Eastern countries. The firm also began to export soybeans and soy products.

As it rebounded from the 1998 economic crisis, SADIA began selling pork to the Russian market, the world's third largest pork importer. Meanwhile it gradually abandoned soybeans, soy products, and beef exports to focus on poultry and pork products. The firm's exports tripled from 2001 to 2005, largely due to the boom in pork exports to Russia. This export growth was aided by several factors explored in the coming chapters. These included regular, coordinated planning to guide export growth and monitoring; strong emphasis on R&D investment and technological applications; low vertical integration (outsourcing many phases of production); internalizing knowledge, logistical, and marketing capabilities; strong emphasis on high-quality and low-cost logistics; and large investments in branding as a central strategy for market positioning and customer communications.

Currently, SADIA exports about 1,000 items to over 100 countries. As a result of the firm's gradual export diversification, by 2005, pork accounted for only 9 percent of SADIA's revenues and 15 percent of its exports. Overall, exports represented about 50 percent of SADIA's gross sales in 2004–2005 (Table 1). The company's dramatic growth in productivity over the span of three decades (Table 2) happened largely as a result of its systematic product and market diversification. In 2009, SADIA merged with its major competitor, Perdigão, to form BRF (Brasil Foods), which controls 9 percent of the global protein trade and has some \$11 billion in net sales.

**TABLE 1/ SADIA: Productivity Increase, 1975–2005**

	2001	2002	2003	2004	2005
Domestic (tons)	77,384	63,892	47,760	49,426	34,334
Foreign (tons)	50,015	87,140	103,689	79,052	105,818
Domestic (US\$ million)	66.8	46.8	42.2	52.9	60.9
Foreign (US\$ million)	81	107.8	144.5	146.9	243.4
Total revenues (US\$ million)	1,709.70	1,605.70	1,902.70	2,501.30	3,421.00
Of which exports	38%	42%	45%	49%	49%

*(continued on next page)*

### Diversifying Exports, Gaining Productivity: Brazil's SADIA *(continued)*

**TABLE 2/ SADIA: Sales of Pork in Domestic and Foreign Markets, 2001–05**

	1975	2005
Meat per carcass (percent)	46	59
Slaughter weight (kilograms)	94	119
Feed conversion rate (kilograms)	3.6	2.6
Production cycle for each 100 kg (days)	179	146

*Adapted from Bonelli, Regis and Armando Castelar Pinheiro, "Pork in Brazil," in Export Pioneers in Latin America, eds. Charles Sabel, Eduardo Fernández-Arias, Ricardo Hausmann, Andrés Rodríguez-Clare, Ernesto Stein. Washington: IADB 2012.*

### *Home Market and Export Gains*

Firms from advanced markets typically have an easier time starting to export than their counterparts in developing economies due to such factors as better access to capital and lower trade costs. For example, it is much easier to export from the US, where the exporting process takes six days, than from landlocked Bolivia, where it takes 17 days.<sup>26</sup>

At the same time, a firm's country of origin affects the gains that the firm makes from exporting. The first way is through the country's level of economic development. To the extent that exporting produces gains in technology and innovation, developing country firms can have more to gain than firms from developed countries. They tend to be farther away from the technology frontier and have more to learn from overseas customers and competitors than do their developed country counterparts.<sup>27</sup> This is particularly the case when developing country firms export to developed countries. Especially in developing or transitional economies, exporters are poised to learn from their international activities and improve performance as a result. This same process can also enable SMEs to realize scale economies.<sup>28</sup>

To be sure, a firm needs a certain level of sophistication and absorptive capacity to make use of the learning and technical knowledge available to it.<sup>29</sup> This very capacity can also be enhanced by exporting. New knowledge sourced from a firm's partners in one market might help to improve the speed and ease of learning from external partners in other markets. As a

capability predicated on the organization and flow of knowledge within the individual firm, absorptive capacity tends to increase with exporting.<sup>30</sup>

The second way in which the exporter's home market influences gains from exporting is the market's size. In small economies such as most LAC countries, market size limits domestic competition. Entering overseas markets is associated with increased competition, which, in turn, provides incentives to the exporter to innovate and enhance productivity. Since domestic competition is already intense in large countries, the impact of export entry on productivity also tends to be less. For example, a 2004 study in the UK finds that exporters have a 2.9 percent higher productivity growth than non-exporters, and that this positive effect is less in industries with a high exposure to foreign competition in the home market. The export premia discussed in Chapter 1 for LAC firms is similarly higher than it is in an equivalent study in the US, again likely because of the large size and intense competition in the US market. Indeed, a recent study of 500 exporters in the province of Santa Fe, Argentina, finds that contact with the export market encourages firms to innovate and also to be the engines of local technological advances.<sup>31</sup>

#### **D. Productivity Gains from Trade Liberalization**

Trade policy in foreign markets also influences firm productivity. For one, liberalization in the foreign export market can enable domestic non-exporters to become exporters, partly because trade opening reduces tariffs and thus lowers domestic firms' prices in foreign markets. In addition, trade liberalization enhances gains from exporting for existing exporters, particularly in the most deeply liberalized sectors.

Trade liberalization enhances export gains in two ways. First, for firms from small countries, liberalization can dramatically expand the size of the market and allow the firm to seize scale economies resulting from a drop in the average cost of production as the volume produced expands. As a result, the firm not only sells more; it also becomes more competitive.

Second, exporters have greater incentives to innovate and become productive when trading partners liberalize. This is because foreign trade liberalization increases exporters' revenues, inducing them to invest in new technologies that lead to productivity growth. Bustos (2011) finds such technology upgrading among exporters in Argentina after tariffs dropped in Brazil.<sup>32</sup>

After Brazil's tariffs applied to Argentine products fell from an average of 29 percent in 1991 to zero in 1995, Argentina's exports to Brazil

quadrupled between 1992 and 1996 while its exports to the rest of the world increased only 60 percent. After Brazil's liberalization, Argentine exporters experienced notable revenue gains, particularly in the most liberalized sectors, and also became more technology intensive (measured as spending on technology per worker) than non-exporters.<sup>33</sup>

There are similar examples in North America of the effects of liberalization. Lileeva and Trefler (2010) find that Canadian plants that started to export or export more as US tariffs were reduced under the US-Canada free trade agreement also engaged in greater product innovation and had higher adoption rates of advanced manufacturing technologies.<sup>34</sup> Firms with relatively low productivity before the free trade agreement particularly benefited. These productivity gains became mirrored in domestic sales in Canada, as the exporters that experienced productivity gains also increased their sales to that country vis-à-vis non-exporters. This finding confirms the independent effect of exporting on productivity. The Box below illustrates the incentives Guatemalan agricultural exporters received to expand their exports resulting from reduced non-tariff barriers, sanitary, and phytosanitary restrictions in the US market. Another Box discusses Peruvian asparagus exporters.

To be sure, liberalization of the domestic market also enhances gains from exporting. First, trade liberalization enables domestic exporters to acquire best-match intermediate inputs at world prices, which makes them more productive and competitive as exporters. Second, imported products, especially from developed countries, often contain minor product innovations that enable domestic entrepreneurs to conceptualize new kinds of products and help them to improve technologies and productivity that aid in exporting. Third, trade openness fuels sifting and sorting in the domestic economy, leading to the exit of unproductive domestic firms and boosting the productivity of firms that withstand foreign competition, which also enhances their success as exporters.

### *In sum: Impacts of Exporting on Firms*

The preceding discussion has elaborated on several key findings from the literature on the impact of exporting on firm performance. Following are the six main results:

- Exporting tends to have a strong and positive impact on firm productivity.

### **Impact of Market Access on Exporters' Productivity: Case of Guatemalan Snow Pea Exports to the United States**

Snow pea production thrived in Guatemala in the early 1980s, but its growth was blunted by overuse of pesticides, which led to a ban on US imports by the US Food and Drug Administration. At the same time, the reputation of Guatemalan agricultural exports as a whole was hurt by an outbreak of intestinal diseases in the US and Canada, which were traced back to imported Guatemalan raspberries.

The US ban resulted in considerable adjustment in the standard industry business model. After an extensive shakeout, the only exporters to survive were those that could provide stronger safety and quality assurances to US buyers (i.e., sufficient quality and traceability to satisfy both the US regulatory requirements and the buyers' own quality standards).

Initially, that shift resulted in a transition toward exporters that relied on a fewer number of larger producers, and an intense focus on quality and productivity. What emerged was a system of contract farming in which the producers received technical packages that included seed, fertilizers, pesticides, and regular visits by company technicians. The farmers ultimately received a share of the profits the export company made on the crop, less the cost of the quality inputs. The shift in the business model highlighted the potential value of establishing cooperatives to offer small-scale producers some of the advantages of the larger producers in the market.

The Cooperativa Agrícola Integral Mujeres Cuatro Pinos, headquartered in the central highlands of Guatemala, is a strikingly successful example of that approach. The producers—all women—grow English peas, string beans, and mini carrots, as well as snow peas, all of which are destined for the US market. Since 2007, the cooperative has grown from a group of 35 women with small vegetable plots to a 350-member organization that manages 415 acres of land. The cooperative's members have quadrupled production from 450,000 pounds to 2 million pounds of vegetables since late 2010 alone. In addition to growing snow peas, the cooperative has begun to upgrade its position in the value chain by processing and packaging, as well as exporting directly to the US market.

External assistance fueled the investments in exporting and quality upgrades. The women of Cuatro Pinos benefited from financial support and technical assistance provided by the International Fund for Agricultural Development and the US Agency for International Development. The success of Cuatro Pinos resulted from expanded access to finance in the form of loans, technical assistance that ensured improved quality assurance, and business training consistent with the demands of managing the cooperative. The women also received help from AGEXPORT, the Guatemalan exporters' association, to learn to export on their own.

### **Peruvian Asparagus: Leveraging Free Trade Agreements for Internationalization**

Beginning in the 1990s, Peru entered into free trade agreements with 14 countries, which included virtually all of its significant trading partners in the region: Mexico, Chile, the MERCOSUR countries, and the members of the Andean Community. Peru also negotiated free trade arrangements with the US, the EU, Japan, and China.

While not necessarily the intent of the agreements, their overall effect was to create a powerful network that complemented the growing prominence of global retailers in the agrifood value chain. As such, these agreements enabled Peruvian exporters the means to achieve scale economies that would not otherwise exist. In effect, Peru eliminated the friction that rules of origin and other standard issues would otherwise have created for its potential foreign customers. Now, for example, asparagus sourced in Peru could be freely exported to any of the consumer markets in the retailers' chain.

The destination of Peru's exports underscores the importance of the country's aggressive pursuit of trade liberalizing agreements. The main destination market for fresh asparagus is the US, which accounts for nearly 75 percent of Peru's exports of that product. The EU (principally Spain) is Peru's next largest market for fresh asparagus, accounting for nearly 10 percent of Peru's foreign sales. Peru's growing season is counter-seasonal to that of the US and Europe, which offers Peruvian producers an important advantage. In addition, the elimination of duties and the facilitation agreements for meeting quality and food safety standards proved instrumental as well.

The benefits of Peru's trade policy are clearly evident in its increased exports to each of the markets. The agreements cover 92 percent of all Peruvian exports and, just as important for products such as asparagus, 83 percent of the country's nontraditional exports. According to the Peruvian Ministry of Economy, the agreements led to marked increases in each of the principal target markets for asparagus, including a 19 percent increase in total exports to the US, a 52 percent increase in exports to Mexico, a 44 percent growth in exports to MERCOSUR, and a 28 percent rise in exports to China.

The factors noted above combine to make Peru the world's largest exporter of asparagus. Virtually all of the more than 220,000 metric tons of asparagus the country produces annually is exported, and more than 70 percent of those exports are of fresh asparagus. By 2003, asparagus had become Peru's leading agricultural export, bumping coffee into second place. Asparagus continues to make up roughly 16 percent of Peru's total agricultural exports.

Nevertheless, Peru's success in tapping export markets has been at the expense of SME producers. While SME asparagus growers once produced the greater part of the country's output, the some 1,500 smaller-scale asparagus farmers today account for only 6 percent of Peru's asparagus exports by value. Despite investments in land and irrigation technology, the opportunity for smaller farms to participate in the asparagus export boom has been limited by their lower production scale, the challenges they face in meeting international quality standards, and the trend in the global agrifood value chain to shift



toward contract production. As a result, SMEs in the sector are often only occasional players in the lucrative fresh asparagus export market.

### *Path to Internationalization*

These challenges led to the creation in 2006 of the Network of Agricultural Production Organizations (REOPA after its initials in Spanish), which knit together a number of local producer cooperatives representing small-scale farmers in the districts of Paijan, Razure, and Chocope, all in the province of Ascope in the La Libertad region of Peru. REOPA members make contributions to the network and receive services in return. Half of these services consist of seed and fertilizers, and the other half is marketing support. REOPA sources 100 percent of what it sells from its small-scale producer members. REOPA began exporting in 2007 with assistance from several initiatives.<sup>a</sup> One, funded by the IDB, helped REOPA member companies implement good agricultural practices and achieve the quality and product safety certification demanded by global buyers. Another involved the efforts of PROMPERÚ and its predecessor PROMPEX to position Peruvian asparagus as a quality product in world markets through the creation of the Asparagus Technical Standards Committee, which established minimum quality standards that exceed those of the Codex Alimentarius.<sup>b</sup> REOPA also benefited from the efforts of the Instituto Peruano del Espárrago, an industry group that promotes proper crop management, seed standards, pest management, and the development of new markets.

All of those initiatives helped create a constructive environment for the smaller producers REOPA represents. REOPA began exporting fresh asparagus directly to the US market—the only farmers association in the region with the capacity to do so. REOPA's success won it one of Peru's annual export awards in 2011.<sup>c</sup> Not resting on its laurels, REOPA improved on that performance: according to recent industry reports, REOPA's exports of fresh green asparagus rose by 40 percent in 2013.

REOPA has also worked hard to enter new markets.<sup>d</sup> One example involves REOPA's collaboration with Colruyt, a Belgian family-owned company that operates 217 supermarkets in Belgium and another 47 in France.<sup>e</sup>

Long interested in sustainable sourcing, Colruyt worked with its Belgian importer, Scana Noliko, to find a farmer organization interested in becoming a part of its supply chain.<sup>f</sup>

Scana Noliko, which itself was originally a Belgian producer cooperative, had worked previously with Gandules, a Peruvian food processor; Gandules led Colruyt and Scana Noliko to REOPA.<sup>g</sup> While the individual small producers in La Libertad were too small to meet Colruyt's needs on a cost competitive basis, REOPA could provide the scale required to achieve Colruyt's standards in terms of both quality and price.<sup>h</sup> This also allowed REOPA to make virtue out of necessity. Nearly 40 percent of the fresh asparagus produced by smaller farmers does not meet REOPA's quality standards for export.<sup>i</sup> But this portion of the crop

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### Peruvian Asparagus: Leveraging Free Trade Agreements for Internationalization *(continued)*

was of sufficiently high quality to be used in the production of canned asparagus for the European market.<sup>l</sup>

Achieving success took time and effort by all parties. The pilot project got caught up in fluctuating prices between fresh and processed asparagus. REOPA suffered an early loss in its sales to Gandules, Scana Noliko, and Colruyt, and Colruyt had to look to other producers to complement the asparagus it received from the cooperative.<sup>k</sup> In addition, REOPA delivered significant quantities of products suitable for the fresh market, but too large for canning.<sup>l</sup>

By the time the project entered its second phase, REOPA had gained a better understanding of the needs of its partners and customers and how the cooperative could plan its own procurement to meet those needs. In the end, REOPA created what has the potential for becoming a profitable outlet for a significant share of its members' asparagus production.<sup>m</sup>

a. See Díaz Ríos, L., *Agro-industries characterization and appraisal: Asparagus in Peru*, Food and Agriculture Organization (2007) ("Agro-Industries) for a general overview of the numerous programs contributing to the establishment of the asparagus industry in Peru.

b. O'Brien, T., and A. Díaz Rodríguez, *Mejorando la competitividad y el acceso a los mercados de exportaciones agrícolas por medio del desarrollo y aplicación de normas de inocuidad y calidad – El ejemplo del espárrago Peruano* (2004).

c. *Ayuda in Acción, Asociación de Pequeños Agricultores de Paiján Recibe Premio por Su Producción y Exportación de Espárragos en el 2011* (Feb. 10, 2012).

d. See, e.g., *Agro 2.0, Perú estará presente en la Fruit Logística 2012* (Jan. 30, 2012).

e. *VECO, Supermarket chain Colruyt linking up with Peruvian smallholders – A glimpse of the canned asparagus chain set up by Vredeseilanden (VECO)*.

f. *Ibid.*

g. *Ibid.*

h. *Ibid.*

i. *Ibid.*

j. *Ibid.*

k. *Ibid.*

l. *Ibid.*

m. *Ibid.*

- The gains from exporting can take several years to harness fully, and most export entrants drop out prior to achieving these gains.
- Export survival is essential to the firm's ability to reap productivity gains from exporting, and it is also key to export diversification.
- Diversified exporters are more productive than undiversified exporters. The more productive firms that already export are more likely to become diversified exporters than are newer and less productive exporters.

- Firms in developing economies in particular have much to gain from exporting as a way to acquire technological knowledge, build capacity, and achieve scale economies.
- Firms' gains from exports are affected by policy variables such as trade liberalization. Foreign trade liberalization results in revenue gains to domestic exporters that enable them to invest in new technologies.

How, then, does firm size impact gains from exporting? Do SMEs experience gains that are distinct from those of large firms? Does firm size critically influence the magnitude and significance of gains from exporting?

While there are few studies on this question, findings in this and the previous chapter can be used to extrapolate. For example, SMEs are more likely than large firms to have low export intensities, be single-product and single-market exporters, and have limited export survival rates. With smaller revenues, they also have more limited tolerance for mistakes than do large firms. As such, SMEs are in a more precarious position and may require a longer timeframe to harness benefits from exporting. At the same time, SMEs that persist also have much to gain in terms of technological know-how, scale economies, and competitiveness.

## **II. Internationalization through Global Value Chains: What Are the Effects?**

SMEs are harder-pressed than large firms to deal with the high sunk costs and internal constraints of exporting. In some cases, SMEs can overcome these obstacles and join the ranks of successful exporters. In other cases, SMEs export by other means, such as by becoming a direct or indirect supplier to a multinational firm and thereby joining global value chains.

To the extent that global supply chains continue fragmenting, as they have over the past three decades, there will be new sources of demand for products and services that SMEs can meet. In theory, SMEs are more agile than larger firms in their ability to take advantage of these opportunities. This is an aspiration as well as an ongoing strategy for countless LAC SMEs. This is also a smart strategy. Research shows that companies that become suppliers to a multinational company tend to increase in productivity, just as exporters do. There are at least three reasons for these productivity increases.

- Global companies are demanding clients; they exert pressure on suppliers to improve quality, drive down costs, specialize, and constantly adapt and innovate.
- Suppliers to multinationals also benefit from information flows, technology transfer, and learning opportunities with the multinational and/or the MNC's lead suppliers; this generates knowledge spillovers and stimulates human and technological capital upgrading.
- Supplying a large customer can enable an SME to produce larger volumes and harness scale economies.

Survey data for the Czech Republic illustrates these effects.<sup>35</sup> Some 50 percent of the Czech suppliers of MNCs reported improved quality control systems in response to MNC requests; 25 percent said that the knowledge gained by doing business with an MNC helped them become exporters; 12 percent reported to have initiated supplying to other members of the multinational network; and 9 percent benefited from MNC recommendations to other companies abroad.

Indeed, as a result of supplying a large and demanding multinational, an SME can grow more productive and become well-positioned to enter export markets. The Box below describes the journey of Embraer's suppliers to exporting. There is ample evidence that firms able to apply knowledge and capabilities acquired in one market with a multinational corporation are better able to serve new markets and customers. Moreover, these subsequent customers benefit from the knowledge that the supplier has gained from its first MNC relationship.<sup>36</sup> Supplying a global company can also enable suppliers to develop their own global brands in such sectors as IT.<sup>37</sup>

The positive effects of joining global value chains can be particularly important for firms that utilize multipurpose technologies. Acting as specialized suppliers, such firms can tap into several different value chains, especially in such manufacturing sectors as automotive and precision and scientific instruments. It could be expected that such firms are less dependent on any one relationship and better positioned to learn across sectors than other firms.

However, learning and other positive effects from participating in global value chains spans sectors, among them, apparel, motorcycles, agroindustry, and computers.<sup>38</sup> Similarly, while knowledge spillovers from the multinational are most readily transmitted to the first-tier, strategic suppliers, they can also reach second- and third-tier suppliers.<sup>39</sup>

### From Suppliers to Exporters: Akaer Engenharia Ltda.

Some Brazilian firms have not only integrated themselves into aircraft producer Embraer's supply chain, but have succeeded in leveraging their experience into direct exports to foreign markets. Perhaps best known is Akaer Engenharia Ltda., a Brazilian engineering firm that began in 1992 by designing relatively minor subsystems for Embraer, and then going on to expand its reach well beyond Embraer and the Brazilian market.<sup>a</sup>

Aerospace is a global market and Akaer's association with Embraer—the world's third largest producer of commercial aircraft—ensured that it would be engaged in international markets from the outset. Akaer applied the lessons it learned in providing design and engineering services for Embraer's Legacy 450 and 500 business jets into exports of its services to other customers and other markets.<sup>b</sup> These customers have included Airbus (on the A380 and A400M) and Boeing (on the 747–8).<sup>c</sup>

Akaer also used its experience with Embraer to tap the defense side of the aerospace market. In 1997, Embraer subcontracted the design and engineering work on the wings, rear fuselage, and tail assembly for the Brazilian Air Force's Super Tucano A-29 fighter plane to Akaer. Akaer has been engaged in updating the plane since then. After six years of 29 percent growth, the defense sector now makes up 17 percent of Embraer's sales.

Akaer has used Embraer's growth in the defense market as a base to extend its own reach into the global defense market. For example, Akaer has formed a partnership with Saab, the Swedish aviation firm that designs and builds aircraft for both civilian and defense markets globally. Since 2007, Saab has not only taken a 15 percent investment stake in Akaer, but has relied on Akaer's engineers to provide the design and engineering expertise for major subsystems on Saab jet aircraft, including Saab's latest project, the Gripen NG fighter.<sup>d</sup>

In this way, Embraer and the Brazilian aeronautics cluster has served as an incubator for firms like Akaer that have succeeded not only in internationalizing, but are contributing cutting edge expertise in one of the most technologically sophisticated manufacturing sectors in the global economy. Defense accounts for 75 percent of the more than \$1 trillion global aerospace and defense market. Akaer's success in translating the knowledge it gained working with Embraer in civil aviation and military trainers has opened the more lucrative side of the aerospace sector to future exports.

In a further move, Akaer signed a memorandum of understanding (MOU) in 2012 with GE Aviation, a production partner of Saab, and with Boeing in the development of the Super Hornet fighter aircraft.<sup>e</sup> The MOU makes Akaer a part of GE Aviation's global supply chain, along with that of Saab and Boeing.<sup>f</sup>

The MOU sets forth a potential role for Akaer in the joint development of future programs with GE Aviation in that company's effort to establish long-term alliances for the use of its engines by civilian and defense end users in Brazil. The proposed programs would include a significant transfer of GE technology to Akaer, as well as training for

*(continued on next page)*

### From Suppliers to Exporters: Akaer Engenharia Ltda. (continued)

Akaer personnel, which would strengthen the Brazilian firm's position in maintenance and assembly, as well as engine inspection and testing, all important niches in the global aviation value chain.<sup>9</sup> In return, cooperation with Akaer helps give GE Aviation and its production partners, Saab and Boeing, the Brazilian presence needed to qualify for future contract opportunities with the Brazilian Air Force.<sup>h</sup>

That collaboration ensured that Akaer would likely play a significant role in the production of the Brazilian Air Force's F-X2 fighter jet, regardless of which firm was chosen as the prime contractor. The Saab Gripen and the Boeing Super Hornet were the leading contenders. Brazil ultimately chose to go with Saab in late December 2013, which will mean a role for Akaer not only in production for the Brazilian military, but also in Saab's future export of F-X2 fighters.<sup>i</sup>

The foundation that Akaer built in the commercial and defense aerospace sectors, and particularly its relationships with the Brazilian ministries involved in aviation and aeronautics, has enabled the firm to push further out onto the technical frontier and into new markets. When China and Brazil began development of their China-Brazil Earth Resources Satellite, Akaer won the contract for the satellite's structural design and engineering.<sup>j</sup> The program, which resulted from Chinese and Brazilian technical cooperation dating back to the mid-1980s, is preparing to launch its fourth satellite in 2014.<sup>k</sup>

Akaer's success is reflected in both its earnings and its exports. Since 2010, the firm's total revenues have more than doubled from R\$15 million to R\$35 in 2013.<sup>l</sup> Over that same time, exports have grown by more than a third, from R\$8 million to R\$11.<sup>m</sup>

a. Akaer Engenharia Ltda., *Akaer—Committed to Excellence*, <http://www.akaer.com.br/eng/presentation> ("Akaer – Excellence").

b. *Ibid.*

c. *Ibid.*

d. See, e.g., UPI, *Saab buys into Brazilian company* (May 9, 2012), [http://www.upi.com/Business\\_News/Security-Industry/2012/05/09/Saab-buys-into-Brazilian-company/](http://www.upi.com/Business_News/Security-Industry/2012/05/09/Saab-buys-into-Brazilian-company/)UPI-45121336598758/#ixzz2sf2w5Ed.

e. SpeedNews, *Military Aviation News*, <http://speednews.com/article/8330>.

f. Boeing, *Boeing Partner GE Aviation Enters Agreements with Brazilian Aircraft Maintenance Companies—Engine assembly, maintenance overhaul facilities identified as potential Super Hornet supply chain members* (Oct. 22, 2012), <http://boeing.mediaroom.com/index.php?s=20295&item=2455>; Saab, *Saab and GE Aviation strengthen ties with Brazilian Aerospace Industry*, (November 8, 2012), <http://www.saabgroup.com/en/Air/Gripen-Fighter-System/Gripen-for-Brazil/News-Media>.

g. aerospace-technology.com, *Boeing's partner GE Aviation enlists Brazilian aerospace firms to strengthen future support base* (Oct. 24, 2012), <http://www.aerospace-technology.com/news/newsboeing-ge-aviation-enlists-brazilian-aerospace-firms-strengthen-future-support-base>.

h. Military Technology, *Saab and GE Aviation Strengthen Ties with Brazilian Aerospace Industry* (November 16, 2012), <http://www.miltechmag.com/2012/11/saab-and-ge-aviation-strengthen-ties.html>

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l. Akaer—Excellence.

m. *Ibid.*

Granted, it is not easy for SMEs to join global value chains. Much like in exporting, supplying a multinational company has entry costs, such as those required to upgrade production to meet rigorous quality standards. Succeeding as a supplier also places demands on managerial and financial assets and organizational capabilities, as will be seen in the coming chapters. And diversification pays in joining global value chains, just as it does in exporting; excessive dependence on one large customer is risky. Chapter 7 will highlight ways in which LAC SMEs may take advantage of the significant opportunities posed by participation in global value chains.

### III. Economic Effects of SME Internationalization

Internationalization has several direct and often significant positive effects on firms, from productivity growth to greater stability and competitiveness. Such within-firm effects translate into various positive within-country effects in the exporters' home economies, such as the following:

- **Job creation.** Productivity spurts associated with exporting do not necessarily translate into job creation; much depends on labor market dynamics. At the same time, SMEs that succeed at exporting also have higher growth rates, which suggests they are more likely than non-exporters to grow larger and employ more workers. Chapter 1 indicated that LAC exporters are larger and also pay higher wages than do non-exporters, and some of this export premia appears to be linked to effects of exporting rather than mere self-selection into exporting. There are also spillovers: exporters help generate jobs in services firms in the domestic market. Each good that is exported requires the use of technology, product design, financing and production services, wholesalers to sell the goods, and logistics and transport services.<sup>40</sup> In the US, for example, direct and indirect spillover services for US goods exports represents an estimated 39 percent of total employment generated by that country's goods exports.<sup>41</sup>
- **Knowledge spillovers.** Exporters can transfer knowledge and skills gained through exporting to non-exporters in their home markets. This can occur through the movement of staff, demonstration effects, or market diffusion, such as when a firm that has acquired new foreign technology sells domestic firms products and services that include that same technology.

- **Productivity gains.** As exporters become more productive, they also access greater resources and gain greater market shares in their domestic economies, which makes the entire economy more productive.<sup>42</sup> For example, more than 40 percent of total factor productivity growth in the US manufacturing sector in 1983–92 resulted from changing output shares across plants. Almost all of this reallocation of output shares stemmed from the rapid growth of exporters vis-à-vis non-exporters.<sup>43</sup> In a baseball analogy, exporters can raise the economy’s batting average. Still another, if not so benign, effect of exporting is the Darwinian process of creative destruction that leads to the exit of the least productive. By winning productivity gains, surviving exporters are poised to outcompete their less productive domestic firms in the domestic market.

To be sure, in most countries, a few large firms account for a large share of exports. Yet the unique contribution of SME exporters to domestic economies remains under-analyzed. Positive effects specific to SME internationalization include the following:

- **Firm growth and survival.** There is strong empirical evidence that small firms grow faster than large ones.<sup>44</sup> Some of these SMEs grow into large firms that have a particularly large impact on national economies. Exporting can play a central role in that growth, as evidenced by such cases as Brazil’s Sadia. For “born-global” companies in small countries, such as ARTech in Uruguay, exporting is necessary, not only for growth but for survival and scale.
- **Employment.** As a source of employment for LAC region’s majorities, SMEs can boost job creation by expanding exports. Moreover, they can do so exponentially when the firm grows from an SME into a multinational corporation. Even though research is not unanimous, SMEs in some studies are found to create more jobs than large firms, and net job creation is higher in SMEs than in large firms.<sup>45</sup> What is more, SME exporters create jobs at a far higher pace than non-exporters. European Union research indicates that SMEs that export achieve 7 percent annual employment growth, as opposed to 3 percent employment growth for non-exporter SMEs.<sup>46</sup> In addition, given that SMEs are typically less vertically integrated than large firms, their export growth can also spur job gains in downstream services as well as upstream in accounting, IT, and website management, among others.



- **Innovation.** Exporting can unlock SMEs' full innovation potential. In particular, the entry of young, high-productivity SMEs into exporting can help these firms invest more in innovation and thus compete harder against large incumbents in the domestic market, thereby benefiting the domestic economy.

Expansion of SME exports is, in short, desirable for economic growth, employment, productivity, and innovation. Thus it is hardly surprising that governments around the world have prioritized SME internationalization. As discussed in Chapter 1, these interventions should be aimed both on the intensive margin—helping existing SME exporters expand their exports—and on the extensive margin—helping larger numbers of SMEs to become exporters. Similarly, given that long-term and multimarket, multiproduct exporters outperform entrants and narrow exporters, public policy interventions could be used to foster SME survival and diversification. In addition, there are significant benefits from encouraging spillovers from exporters to non-exporters, such as sharing of knowledge. In the next chapters, we will turn to the challenges that should receive priority attention.

## IV. Conclusion

LAC SME exporters outperform non-exporters in productivity, wages, sales, and skill levels. High-performing companies tend to embrace international markets and become exporters to begin with; i.e., top-performing companies self-select into exporting. At the same time, recent research shows that exporting and internationalization have independent positive effects on firm performance. Following are six main conclusions:

- **Exporting increases firm productivity and survival.** Exporting has various positive effects on firms, including revenue diversification across markets, reduced volatility of sales, increased capacity utilization and scale economies, higher incentives to innovate and invest in R&D, and learning-by-exporting, which improves managerial practices, strengthens firm capabilities, and uncovers market opportunities.
- **Gains from exporting vary according to the nature of the firm.** Gains from exporting are critically affected by a firm's survival in the export market, its export diversification, its country of origin, and the trade

policy environment in which it operates. Firms from developing countries have most to gain due to their limited technology, capabilities, scale, and competition in their domestic markets. Exporting opens opportunities to access foreign management practices and technologies, and to exploit scale economies. Further, firms that are more export intensive, firms that have survived as exporters for a number of years, and multiproduct exporters, all tend to achieve higher productivity gains from exporting than do firms with low export intensities, single export products, and/or single export markets.

- **The gains from exporting can be immediate, but are greatest over the long term.** Gains from exporting can occur both overnight and over the course of several years. There are many reasons for the lag. For example, gains may kick in only after the sunk costs involved in new market entry and product launches are recouped, and after the firm has had time to absorb and benefit from innovation and enhanced managerial capabilities. Export survival is thus of prime importance to LAC SME exporters.
- **Participation in global value chains boosts productivity.** Much like exporters, firms that become direct or indirect suppliers to a large multinational firm tend to experience a productivity boost. Multinationals offer both sticks and carrots. They pressure suppliers to improve quality, drive down costs, specialize, and constantly adapt and innovate. They also offer suppliers new information, technology transfer, and learning opportunities. Suppliers that have worked up a sufficient absorptive capacity have most to gain and are best positioned to subsequently become direct exporters themselves.
- **Small firms can make particularly great gains from exporting.** SMEs with sufficient absorptive capacities can achieve particularly large gains from exporting, given that they often start from farther behind large firms in terms of productivity and scale economies. At present, many LAC SMEs struggle merely to survive because of low productivity and/or their decision to export only occasionally. As such, they have the latent potential to grow through exports. But they also face different and often more severe challenges than large firms in unlocking that potential. These constraints are addressed in the following chapters.
- **SME exports can produce major gains for LAC economies.** SMEs are a backbone of LAC economies, and SME internationalization benefits

the region in several ways. Exporter SMEs generate various positive externalities in their home economies, from raising overall productivity levels to generating employment in down—and upstream industries and imparting new knowledge and skills to non-exporters. For SMEs, exporting is also an excellent growth accelerator that can transform them into large firms that offer employment to tens of thousands of people. Moreover, exporting can give SMEs fresh resources to invest in innovation, a key driver of economic growth that is sorely needed in Latin America.

Supporting SME internationalization could yield a high return on investment. However, unlocking the potential of SME exports in the LAC region requires identification of the specific bottlenecks that the region's SMEs face. The following section addresses these constraints.

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# **Obstacles to LAC SME Internationalization: The Context for Action**

SECTION





Internationalized LAC SMEs can greatly benefit the region's economies. Entrants expand their countries' product baskets, while firms that serve international markets for a sustained period of time contribute significantly to national export growth. Internationalization is also associated with enhanced firm performance. SME exporters consistently have higher sales, more diversified revenue, greater labor productivity, and higher wages and employment levels than non-exporters. Yet many LAC countries trail comparable economies in SME internationalization in both manufacturing and services, with lower levels of export participation by firms, diversification, and sales. The question is why.

SMEs are at a distinct disadvantage in internationalizing. Research findings underscore the many obstacles smaller firms face as compared to large firms. It is said that to internationalize successfully, SMEs must overcome the liabilities of smallness.<sup>1</sup> These liabilities include the relative difficulty and/or inability to shoulder additional up-front and ongoing costs; overcome logistical and trade restrictions; navigate higher levels of market, operational, information, and management complexity; restructure internal processes and capabilities; access requisite financing and sales relationships; and in general, face more sophisticated demands on multiple fronts, including dealing with a new universe of competitors.

Why is firm size so critical? As with any growth activity undertaken by an individual firm, exporting and other forms of internationalization make new demands on the firm's management and capabilities and exposes it to new risks. For a firm to trigger export sales in order to grow revenues and customers, it must invest time, capital, and other resources. Moreover, while management can influence the level of investment and probability of success, the time lags between outlays and outcomes are often significant, and the business returns themselves are inherently uncertain. This double whammy means that size doesn't just matter; it matters a great deal.

In short, not only must a firm be equipped to manage the barriers and challenges to exporting. It must also have sufficient additional cushion to make it through a process of course corrections and improvements in the hopes of generating potential returns in the future. For all of these reasons, SMEs that intend to enter and/or expand in the export arena must stretch beyond their current state far more than large firms. Meanwhile, they can draw on far fewer resources and assets than their large counterparts.

This section presents the following three primary sets of costs and constraints that slow and/or altogether block exporting for SMEs:

1. External obstacles related to internationalization that affect SMEs in particular, including entry costs, trade costs, trade compliance, and informational barriers.
2. Requirements that are internal to the firm, i.e., the managerial, strategic, and operational assets and capabilities that are central to internationalization and especially difficult for SMEs.
3. Challenges the region's SMEs face in accessing finance, the critical yet sorely lacking fuel for SME internationalization.

These constraints are especially vexing to SMEs in Latin America and the Caribbean. The region tends to be characterized by (among other barriers discussed) comparatively high trade costs, elevated costs of capital, and gaps in workforce skills increasingly needed for surviving in the international markets.

To be sure, the challenges addressed here are linked. For example, firms' assets and capabilities depend in part on access to financing, while information barriers are related to a plethora of issues such as sunk costs, trade compliance, intra-firm capabilities, and access to affordable credit. Our purpose in isolating each set of constraints in separate discussions is twofold: to highlight the specific dynamics and challenges at stake, and to arrive at targeted policy guidance.

Methodologically, the section is based on an extensive body of literature that describes these various constraints to SME internationalization and the circumstances under which they are most serious. Due in part to the limitations of available data, most of this literature is not specific to the LAC region, nor always to developing regions. However, insights on the liabilities of smallness from other regions are just as applicable and instructive to LAC.

It is important to note that the literature on obstacles to internationalization focuses largely on exporting. From a logical (but not evidentiary) perspective, understanding how these challenges operate can help illuminate certain advantages to other internationalization pathways, most notably, participation in global value chains. We discuss these issues separately in Section III, where GVCs are explored as a potential high-value opportunity for the region's SMEs. While much of the original literature is highly technical, we have extracted the core insights and presented them in non-technical language, so that the logic and implications are accessible to a broad range of public and private sector leaders.

This section is designed to drive a holistic, thoughtful, and targeted discussion of the major bottlenecks to internationalization and how they can be mitigated most effectively to support LAC SMEs with good potential to compete, survive, and thrive in the international arena. We offer this material as a context for action, i.e., as a critical lens through which to evaluate, prioritize, develop, and implement solutions for LAC SME internationalization.

## Endnote

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**T**his chapter examines the external costs and constraints that impede and/or block SME internationalization, and which are often particularly vexing to LAC SMEs. It contains the following four parts:

- Sunk costs.
- Trade costs.
- Trade compliance.
- Information barriers.

## I. Sunk Costs

Exporting is costly. The first set of costs that firms face when starting to export or expand to new markets is sunk costs: the many up-front costs needed to enter a particular export arena. Key among them are costs to gather market intelligence and weigh alternative export opportunities, vet and establish distribution, build export-related capabilities within the organization, hire and/or train personnel, learn about customer needs, and possibly obtain product certifications and/or tailor products to local markets. In addition to being costly, many of these activities occupy management resources for long periods of time. All of this must be done before the export initiative can begin.

The purpose of this subchapter is to present core findings on how sunk costs affect LAC SME exporters and would-be exporters. We show why sunk costs are especially onerous for SMEs as opposed to large firms. We also explain how sunk costs function within the overall context of a firm's assessment of their unique return on investment (ROI). We then use this background to explore several ways in which sunk costs vary, highlighting what these variations indicate for the means by which SMEs may deal with the sunk cost barrier.

The first part of this material discusses the liability of smallness with regard to sunk costs, and the role sunk costs play in firms' overall return on investment calculus. The second part discusses major drivers of variation in sunk costs, and by implication, how firms can and often do choose

opportunities and strategies in line with their means. Part three lays out conclusions and areas of policy action.

It is important to note that the literature related to sunk costs is often highly technical and/or theoretical. Our purpose is to extract and explain the key insights in nontechnical, accessible language that will aid consideration and discussion by stakeholder leaders concerned with SME internationalization.

## **A. How Sunk Costs Act as a Particular Barrier to SME Internationalization**

### **1. The Liability of Smallness**

In 1995, Bernard and Jensen published the first in a series of papers that became a turning point in the literature on exporting. Their studies used comprehensive longitudinal data from regularly executed, statistical surveys in the US to examine differences between exporters and non-exporters. This work was followed by many studies by other scholars who applied its logic and methodology to similar datasets from diverse world regions. What emerged was unequivocal evidence that exporters are *a priori* more productive than non-exporters.<sup>1</sup>

In fact, as we documented in Chapters 1 and 2, LAC SMEs that export typically outperform non-exporters on multiple beneficial measures, including productivity, wages, capital intensity, skill-intensity, growth, and job creation.<sup>2</sup> Additional quantitative studies from the region support these findings. A multiyear study of nearly 5,000 Chilean plants (many in single-plant firms) revealed that those entering foreign markets were 19 percent more productive in total factor productivity and paid approximately 20 percent more in wages compared to non-exporters. Similarly, a multiyear analysis of 192 statistically representative SMEs in Argentina showed that average sales per employee was positively and significantly associated with a firm's export status.<sup>3</sup> A model covering a half-decade of plant performance in Mexico, and fully a decade in Colombia, showed similar and significant results among export entrants.<sup>4</sup>

This empirical evidence is explained theoretically by Melitz. By adapting a rich literature concerning firm heterogeneity and entry/exit decisions to industries, Melitz constructed a model that analyzes the role of productivity as a catalyst for entry into and exit from international trade. The existence of sunk costs lies at the core of this framework. Only the subset



of firms that are more productive self-select into export markets. Less productive firms cannot export because sunk costs pose an entry barrier to exporting that they cannot overcome.<sup>5</sup>

Per Melitz, it follows that the requirement for higher productivity in order to overcome the entry cost into trade strongly favors large firms over SMEs, because they are more likely to enjoy greater economies of scale and scope. Moreover, the larger the firm, the greater its ability to sustain a certain level of sunk cost. Many studies appear to support this notion by showing that SMEs are less likely to start to export than large firms. For example, in the Chilean plant study, medium and large plants were 5 percent and 10 percent more likely to start exporting than small plants, respectively, while exporters as a group were fully 60 percent larger in terms of sales than non-exporters. Even more, large firms often face reduced sunk costs when compared to an SME as a result of their more sophisticated internal capabilities and staff, more extensive external assets such as foreign networks, preexisting distributor relationships/contracts, and market intelligence.

Thus, a large firm typically faces both lower relative sunk costs as well as greater resources when it sets out to pursue any particular export opportunity. From another angle, even in a situation where sunk costs are identical for firms regardless of size, the same level of investment would be far more burdensome to an SME as a percentage of revenues and/or total free cash flow. Indeed, for an SME, sunk costs can be substantial. A detailed study of entrants from Colombia in three distinct industries (leather, knitting, and chemicals) found entry costs to be around \$400,000.<sup>6</sup>

It is also important to SMEs that large sunk costs are “sticky.” In this repeatedly observed pattern in the data, known as *hysteresis*, the firms’ current foreign market participation is influenced by their prior experience in foreign markets.<sup>7</sup> Incurred sunk costs are a source of export persistence because once firms have “sunk” their entry costs, they rely on a stream of current and future profits to recoup this investment. Yet this very stickiness makes new export entry that much more risky for an SME already facing high sunk costs (especially as a percentage of firm resources) on top of considerable uncertainty about its future export success.

In sum, sunk costs uniquely disadvantage SMEs from export entry. This observation sheds light on a key impediment to internationalization for the region: the fact that a low percentage of LAC SMEs export even 1 percent of sales (with a regional export participation rate of 13.4 percent, and as low as 6 percent in several individual LAC countries).<sup>8</sup>

## ***2. Sunk Costs in the Context of the Firm's Overall Financial Considerations***

While critical, sunk costs are not the only financial requirements that determine whether, where, and to what extent an SME will export. The overall financial consideration contains several variables. The first variable we examine is per-period fixed costs, another individual cost requirement. We then turn to the return on investment (ROI) assessment, which firms typically use to evaluate a given project because it sheds additional light on the sunk cost constraint.

Unlike sunk costs, per-period fixed costs continue throughout a given export initiative. These costs may include set levels of transportation and logistics, customer service, relationship management, marketing campaigns, unique product and packaging enhancements, recurring certifications, and so on.

As would be expected, high fixed export costs are associated with low propensity to export, and vice versa. Examination of annual expense data reported by Chilean industrial firms showed that moving from the 25<sup>th</sup> to 75<sup>th</sup> percentile of fixed cost indices was associated with a drop in export propensity of 6 to 12 percent. This same study revealed that high-productivity Chilean non-exporters faced high fixed export costs, a factor that likely kept them from entering the export arena.<sup>9</sup> As with sunk costs, high fixed costs operate as a constraint on export entry. At the same time, fixed costs further impact the decision not just to enter, but also to stay in a given market.<sup>10</sup>

These interrelationships can best be understood by considering how firms typically determine whether and at what level to move forward on any given growth project. Several variables combine to generate the ROI projection. Only one is up front: the sunk cost, or initial entry investment. The remaining variables affect per-period returns. These include per-period fixed costs, per-period net sales, the relative timing and duration of cash inflows and outflows, and the firm's risk-adjusted discount rate or cost of money over the multi-period horizon.

Let's look again at the Chilean example. Moving from the 25<sup>th</sup> to the 75<sup>th</sup> percentile in fixed cost indices was associated with a jump in average firm-level export volume of fully one-third to one-half in magnitude. As per-period fixed costs increase (with all other variables remaining constant), so too does the requirement to sell more in order to exceed profitability thresholds.

Broadening our view to include ROI opens up a more nuanced discussion of sunk costs. When a firm evaluates a given level of sunk costs, at least three high-level considerations come into play:

1. Whether the firm is able to overcome the initial financial hurdle on an absolute level.
2. Whether it is worth overcoming the sunk cost constraint given the expected profitability.
3. Whether overcoming these particular sunk costs is the best use of investment capital (highest projected ROI) given the universe of opportunities available to the firm.

These considerations give rise to a new set of questions. Can the individual firm exert any degree of control over sunk costs? If so, how and under what circumstances? Similarly, can the firm control any of the other variables in the ROI equation, such as the level of risk (which affects the discount rate), the level of per-period fixed costs specifically related to exporting or the projected scale of net sales? And what strategies are available for firms in light of uncertainties about the level of sunk costs and ROI?

The next section explores how sunk costs vary in several key areas and how strategies of firms may take advantage of this variation in light of their financial calculus and costs requirements. Areas addressed include the following:

- Differences by export sector.
- Differences by destination market and country.
- Differences by successive export opportunities.
- Choice of export frequency and entry strategy.
- Direct vs. indirect exporting.
- The impact of learning and spillovers.

## **B. Variation in Sunk Costs and Implications for Firm Strategies**

### **1. Differences by Export Sector**

Since sunk costs vary by sector, exporting is easier for smaller firms in some sectors than in others. Chapter 1 showed that regional export entry (and exit) rates are highest in sectors where average export transactions are smallest. In such sectors, even some weaker firms not poised to survive can test out exporting, learn about their level of export success, and dispel uncertainties related to their sunk cost and ROI estimates. These can be valuable activities if the firm were to subsequently exit but reenter later on.

Sectors vary in their sunk costs for several reasons, including required economies of scale, higher capital intensity, and stringent quality standards. According to one study on global patterns in export entry and exit, in such sectors as coins, entry costs are low, and even very small exporters can easily participate. In contrast, in such sectors as fish, small exporters tend to be unable to overcome the sunk costs of meeting high quality standards and investment in freezing technology. (Per-period fixed costs are also higher in fish, due to the ongoing need to ship frozen product.) For these reasons, export entry rates are far lower in fish than in coins. Worldwide—as in LAC—entry and exit rates are highest in industries where small sales are possible and sunk costs lower.<sup>11</sup>

Similarly, data on LAC exporters show that for manufacturers of straw, silk, and fur skins, the mean LAC entrant's annual export value is below \$10,000, and average exporter's annual export value is less than \$50,000, indicating the presence of small export transactions. At the other extreme are meat, ores, and fertilizers, sectors with rigorous quality standards and/or need for large operations and scale economies. Here the mean entrant's annual export value is over \$400,000, and the average exporter's export value is over \$2 million. In these latter sectors, small export trials are likely less possible, and SMEs in countries with strong comparative advantages in such sectors can be harder-pressed to export.

## ***2. Differences by Destination Market and Country***

The level of sunk cost also differs depending on the characteristics of the new export entry. As confirmed by sophisticated econometric models, the analysis has two components: country-specific sunk costs and market-specific sunk costs.

In this context, a “market” is defined as a particular product in a particular country. Thus, country-specific sunk costs may include such items as acquiring information about a country's business culture, governance, and legislation, or investing in bilingual staff. Market-specific sunk costs may include acquiring information about product demand, industry structure, and competition, or investing in distribution.<sup>12</sup>

As one example, sunk costs are typically lower when firms are able to glean market intelligence more quickly and at lesser cost. This may be the case for neighboring countries, when countries share a common language and cultural heritage, or (as in the case of the Chinese Diaspora) when markets share related communities of business people willing to act as trusted

agents and strategic partners. Within the ROI framework described earlier, the lower sunk cost will make a project more attractive on an absolute level and also when compared to other uses of capital. Interestingly, some of the same opportunity attributes that reduce the sunk cost may also reduce per-period fixed costs or enhance projected net sales.

Such variation by country and market implies that sunk costs can be controlled to some degree by the selection of export opportunity. Granted, resources matter: companies with greater capabilities, networks, or access to information face lower sunk costs than their less well-endowed counterparts when pursuing the same export markets. Nonetheless, even small firms with fewer resources can shape their strategies to the extent that they are aware of opportunities and can select lower cost options, such as entering markets with fewer trade restrictions and/or compliance issues, or markets in which the customer requirements for their product set are virtually identical to domestic dynamics.

Differences in sunk costs by country and market of destination interact in important ways with the variations we have seen by sector. In destination countries/markets characterized by high costs of exporting, the sensitivity of entry to industry transaction size is larger, meaning that when sunk costs and per-period fixed costs are large, the ability to enter a foreign market with small transactions is relatively more important.<sup>13</sup> This finding highlights the impact of selecting lower-cost opportunities, and particularly in sectors with generally high sunk costs.

In sum, there are sector—, country—and market-specific components to sunk costs. Given that SMEs may not be aware of these differences, they can benefit from education on how to tease out the relevant components in order to compare options and build the ROI calculation before engaging in the export initiative. Further, while SMEs have scant leeway to change sectors, policymakers and trade practitioners can take into account sector dynamics in developing support mechanisms.

### ***3. Differences by Successive Export Opportunity***

It follows from the last two parts that each successive market or product entry is associated with a new and unique level of sunk cost. For example, the level of successive investment will depend on whether the firm is staying within, or is alternatively moving into, a new country or market. This is important because leveraging existing distribution channels and/or in-depth knowledge about customer groupings and competitive requirements can significantly lower the next entry investment.

Overall, successive investment hurdles play a large role in explaining why the majority of LAC SME exporters are “narrow” exporters, i.e., they export just one or two products to one or two countries, with about one-third exporting just one product to only one market. The outlay for additional sunk costs may simply be too prohibitive, and particularly if earlier sunk costs have not been fully recouped.

Even when smaller exporters seek to expand in foreign markets, the least capital-intensive route is to avoid new sunk costs. They can accomplish this by doing more of the same: scaling same-product sales within existing market opportunities, often by deepening within existing relationships. These are also typically the least risky (highest certainty) strategies.

#### ***4. Choice of Export Frequency and Export Strategy***

We have seen that one of the major issues facing the region’s exports is that its SMEs have extremely high drop-out rates. In fact, of LAC SME entrants, only 25 percent continue exporting after three years.<sup>14</sup> One reason is simply this: sunk costs differ across firms by virtue of the strategies they select.<sup>15</sup> In technical terms, firms are heterogeneous, that is, they differ in their capabilities. Heterogeneous firms will differ in their choice of export strategies and trade technologies according to their predilections and needs.

One of the trade technologies that varies widely is distribution. One management team may opt to build distribution of its own in a foreign country, while another may contract with one or more free agents. The former strategy involves a higher sunk cost, while the latter entails greater variable costs and less profit per unit of sale. The higher sunk cost strategy will result in a more permanent trading pattern, while the higher variable cost strategy will produce a relatively temporary trading pattern.

A dynamic model using a dataset of Hungarian manufacturing firms demonstrated that firms will sort themselves out according to their ability to overcome the sunk cost. The more financially constrained firms tended to shy away from permanent distribution networks and trade temporarily, either by an on-again-off-again participation or by exiting after a short period of time. The more productive and financially less constrained firms chose a different route. According to the study, doubling the firms’ total factor productivity was associated with a 5 percent increase in the probability that trade flows would be long term.<sup>16</sup>

This same logic can be extended to LAC. Note that particularly for the region's smaller SME exporters, exports tend to make up a lesser share of total sales than for SMEs in economies of comparable levels of development. What is more, most of these firms are very small and therefore constrained by a lack of excess capital to invest in growth. These facts strongly imply that when LAC SMEs enter the export arena, they do so by pursuing strategies (such as ad hoc distributor relationships) that will allow them to enter the market at small cost. But it is these very strategies that have the least staying power in the marketplace. As such, we can see that sunk costs are an important driver leading to the sporadic exporting patterns and extremely high drop-out rates among LAC SMEs.

The timing and levels of sunk cost to be incurred, as well as those of net sales/profits, are highly uncertain prior to experience in a particular foreign market. After entry, the firm learns about the market and the relative success of its entry strategy and its own capabilities. As a result, SMEs may select less permanent trade technologies in response to the uncertainty inherent in export entry.

When the firm makes its choice of distribution, it considers not only the absolute level of sunk costs involved but also the other variables that will determine its projected return on investment. Investing in high sunk-cost export strategies makes more sense for opportunities that are likely to be more profitable.

Higher potential opportunities would include the following:

- Markets of larger size and/or with limited competition.
- Markets that offer lower compliance costs for a given product set or preferential market access.
- Markets that are geographically proximate, and thus generally require lower transportation, information, and coordination costs.
- Market segments requiring little, if any, product localization or product quality improvement relative to what the firm sells domestically.

Studies confirm that firms are more willing to invest in high sunk costs when their probable net returns are larger and/or more certain. This general conclusion was borne out in the Hungarian study cited above, which found that trade patterns were more stable for destinations of greater proximity and also of higher GDP.

### 5. *Direct versus Indirect Exporting*

Another type of distributor decision is indirect exporting. Given the enormity of the sunk cost constraint on SMEs, it is not surprising that a portion of these firms favor indirect over direct exporting as a means to overcome otherwise prohibitive economics. In this intermediation process, the much smaller producer sells to a much larger intermediary, which serves as an aggregator, handling export logistics and selling in the final market for relatively homogenous products from many different firms. Because of their size and deliberate trade specialization, intermediaries in some cases can be better equipped than SMEs to overcome certain market-specific constraints of international trade, such as various trade costs and search-specific information barriers.

Overall, intermediaries are relatively more important for overseas markets that are more costly and harder to penetrate, due to higher tariff levels, distant geographical location, greater language barriers, and greater regulatory barriers to trade.<sup>17</sup> Intermediaries may also help less-efficient firms to start exporting and supplying foreign markets.<sup>18</sup> This may explain why a review of Chinese trade transaction data showed that intermediaries accounted for roughly \$168 billion of China's exports in 2005, or 22 percent of the total.

Indirect evidence using matched importer-exporter transaction data for Chile and Colombia shows that, in general, when one party to an international trade transaction is small, it engages with few other traders, while a large party will engage with multiple other traders. In the Chilean and Colombian data, more than half of exporters sell to only one importer, whereas the very largest exporters (top 99<sup>th</sup> percentile) sell to 19 importers. This same dataset shows that more than half of importers deal with only one exporter while the top 99<sup>th</sup> percentile importer deals with nine exporters.<sup>19</sup> Note however that this analysis cannot distinguish between sales to an intermediary and sales to a single overseas buyer, which might be consonant with SME use of less permanent trade technologies, as described above.

Similar data on Chile-Argentina trade shows that large intermediaries appear to play an outsized role in facilitating trade among low volume countries and in low volume products exported by small firms.<sup>20</sup> On the importing side, intermediation appears to enable small and low volume importing countries, such as many LAC countries, to access a greater variety of products from a greater number of countries. This in turn indicates that intermediation can help LAC firms to start exporting or to diversify into new niche products and markets, including smaller export markets. As such,



a larger intermediation sector might be especially useful for encouraging intra-regional trade among LAC SMEs.

In general, intermediation does not appear to be a widely used strategy for LAC SME exporters. The available survey data on regional export patterns in Chapter 1 indicate that a relatively low 5 percent of LAC SMEs export through intermediaries. While the literature about intermediaries is expanding, more research is necessary to understand LAC SME use of intermediation.

### **6. *The Impact of Learning and Spillovers***

Firms have yet another useful central tool at their disposal for reducing successive sunk costs: the ability to learn from experience. They acquire this knowledge in a variety of ways. A firm may learn from past experience with the same product in the same country, from selling other products in the same country, and/or from exporting these same products to other countries. Each case would produce slightly different lessons, such as the following:

- At the country level, a firm may learn about the business culture, exporting procedures, and governance qualities.
- At the product level, a firm may learn about the nuances of customer requirements and the shape of the demand curve.
- At the market level (product-country), a firm may learn about distribution networks and competitive dynamics.

The more relevant the lessons are to the next potential exporting opportunity, the more they appear to move the needle on sunk costs—often significantly so. Thus, firms with previous experience exporting a product to a particular market are more likely to start exporting a different product to the same country, or to sell the same product to another market. A model representing the experience of Chilean firms from 1991 to 2001 revealed that a 10 percent increase in the cumulative export value of a product by a firm increased the probability that the firm would sell new products into the same destination by 2.7 percent, and the likelihood of selling the same product into a new destination by 2.3 percent.<sup>21</sup> A study on Norwegian seafood exporters indicated that when firms sell a certain product into a specific country, it becomes far more economical to sell other products into that same country.<sup>22</sup>

These findings speak to the need to find ways to reduce the largest components of sunk cost facing exporters, which are those of finding

new customers, new distributors, and learning how to best serve them. These are also some of the greatest sources of uncertainty in export entry. The benefits from learning are yet another reason that export survival matters to the region's SMEs. In a very real sense, as firms internalize learning effects, entry into other markets becomes easier. But do new exporters receive benefits from learning as well? Specifically, do these new entrants learn from the experience of other firms? Despite earlier ambiguities in the evidence, recent work strongly suggests that the answer is yes.

Relevant export knowledge is likely to spill over from one firm to another in the case of country- and market-specific exporting. The impact is positive and substantial when a large number of other exporters are involved. It is even more pronounced when the firms are selling the same products. In the Norwegian study, the export intensity of these other firms was also strongly correlated with export entry as well as export survival. That is, the more exporters and the more exports in a given product category, the more opportunity was created for valuable types of learning. This pattern is especially interesting in that it demonstrates the positive influence of learning on meeting the challenge of increased competition. It appears that firms are able to learn from the experience of others in their industry in ways that reduce up-front information costs, for example, the cost of searching for and vetting opportunities, customers, and distributors.

Spillover effects are also quite significant when a large number of exporters from the same country sell the same product in the destination market. A 1998–2003 study on French exporters shows that such spillovers particularly aid the non-exporter's export decision, rather than boosting its exported volume.<sup>23</sup> This indicates that spillovers alleviate fixed costs rather than variable costs. The effect is strongest when the exporter causing the spillovers is located nearby and exports a specific product to a specific destination. It is not significant when applied to all products and destinations. In other words, firms exporting a given product to a given market are more likely to inspire others to do the same.

On this same point, a study of African exporters found that the probability of success for a new entrant in a new product and market rises with the number of firms exporting the same product from the same country to that same market.<sup>24</sup> Spillovers not only reduce entrants' sunk costs; they also shape risk and profitability. Consider the situation where a new entrant observes the decisions made by its compatriot firms. Here, an existing track record of exporting success functions as a signal of market receptivity and

demand, increasing the relative certainty of potential returns from exporting for the new entrant.

### ***C. Conclusions and Policy Implications***

While SME exports are critical for LAC region's export growth and diversification, they are all too often held back by steep sunk entry costs. Our discussion has focused on the role of these costs in constraining SME's export entry and expansion. We presented long-standing and repeated findings from regions around the world that sunk costs unduly burden SME internationalization. A seminal model constructed by Marc Melitz at Harvard University provides the theoretical underpinning. There are several reasons for the impact of sunk costs on SMEs, including the need for higher productivity to overcome the cost barrier, a smaller firm's inability to leverage existing foreign assets to reduce the level of entry investment, the much higher percentage of total available capital which sunk costs demand of a small firm, and the relative inability of SMEs to manage the high levels of risk which "sinking" these costs entails.

We then looked at how sunk costs function within the context of a firm's financial assessment (ROI) of a potential export initiative. The ROI shows the firm's ability to control its level of sunk costs as part of a financial calculus, and the importance to the firm of doing so. This ROI calculus includes per-period fixed costs, potential profitability (net sales), and level of projected risk for each export initiative. With this analytic lens in place, we examined how sunk costs vary and how firms can—and do—use these differences to advantage in selecting export opportunities, strategies, and mechanisms. We found that sunk costs differ according to sector, by foreign destination and market within those countries, and by frequency of exporting and distribution technology (including intermediation). The underlying dynamics revealed that by reducing key components of the sunk costs, such as the costs of gathering critical market intelligence, establishing distribution, or meeting quality and other compliance standards, new export opportunities become relatively more affordable. These findings also helped to explain why the typical LAC SME exporter sells only one or two products to one or two countries, and why churn rates are very high for the region's SME exporters.

The discussion then explored recent evidence that firm-level learning can significantly reduce sunk costs, particularly when the knowledge acquired is specific to a country and/or market within a country. This adds weight to the emphasis on export survival for LAC SME internationalization.

It is clear that firms can learn from their previous export experience as well as from the experiences of other firms. Such knowledge spillovers help remove uncertainty about market receptivity and costs, and they are especially potent among firms in the same sector and from the same home countries.

These insights help to confirm the rationale for the region's continued focus on enhancing SME productivity through more skilled labor forces, greater access to technology, and reduced regulatory hurdles. At the firm level, these same policies promote SME internationalization, because the sunk cost constraints strongly favor more productive firms to enter into exporting.

At the same time, the importance of the subject demands further dialog on new and/or targeted policy remedies, including measures such as the following:

- Support SMEs in overcoming the coordination barriers and asymmetries of information and technology that so often saddle SMEs with high sunk costs relative to larger firms. This is a natural field of work for export promotion agencies. Additional support could be provided by export committees, virtual clusters, and other collaborative arrangements across stakeholders by sector. One such example is the Colombian flower industry, which in its early years faced entry costs that were prohibitive for all but the very largest companies. Then, collective action by the industry association resulted in moves by numerous exporters and the government to set up reliable and secure air transport alternatives for shipping to the US and Europe.<sup>25</sup> Similarly, a review of sector-specific SME export consortia in Argentina (especially in the period since 1998) reveals that that successful consortia played such roles as encouraging the sharing of experience among participating firms and joint promotion in destination markets, which reduced cost per firm.<sup>26</sup> Worldwide, measures that pool resources among firms and/or public-private partnerships have also been useful in finding, vetting, and establishing export customers, partners, and distributors.
- Encourage knowledge spillovers by shaping mechanisms that incentivize SME exporters to transmit their hard-won knowledge about success drivers, markets, and opportunities to SME non-exporters and beginner exporters. As in the example above, collective measures have proven to be an important component, with current SME exporters sharing information and guidance in order to accelerate learning and reduce the risks inherent in expansion.

- Strategically focus LAC SMEs on the most attractive export opportunities, that is, sectors and markets that promise lower levels of sunk cost, reduced risk, and greater potential returns. This could involve encouraging SMEs to try out exporting in sectors with low entry costs and methodically build their export commitment. Even if not immediately successful, low-cost export trials can be a high-impact component in an SME's long-term strategy. By learning about exporting in a trial, an SME will be better positioned to export at a later time. Conversely, in sectors with high entry costs, different kinds of interventions are needed, with priority given to the most effective way to manage and/or join with other firms to overcome the requisite entry costs. Because export promotion agencies operate with limited bandwidth, selecting a suite of targeted solutions would enable Export Promotion Agencies (EPAs) to choose activities and deliver information most likely to provide high value in furthering SME exporting. In Chapter 8, we explore selling to the US Hispanic Diaspora as a prime example of such a targeted export strategy.
- Increase affordable financing options for SME export entry along with the associated information, and access asymmetries which constitute the current market failure. Enhancing access to affordable financing would enable stronger SMEs to overcome the entry investment while simultaneously improving their projected ROI on new export opportunities. The critical need to improve access to credit is explored in more depth in Chapter 5, and related initiatives are covered in Chapter 6. Some of the many government-led practices used worldwide include SME loan guarantee programs, comprehensive information portals specific to capital sources and financing procedures, training programs to improve SME know-how of export financing techniques and requirements, and public sector co-investment in SME internationalization alongside equity funds.
- Encourage SMEs to use the Internet for exporting. The Internet offers a powerful means to level the playing field for SMEs. It helps reduce several of the contributors to sunk costs, such as gathering deep market intelligence, selecting appropriate distributors, and marketing at low cost to niche buyers who may be on the other side of the planet. With Latin American and Caribbean SMEs relatively well-connected to the web, there is a place for concerted export promotion interventions for SMEs to leverage the Internet for exporting, as we discuss in Chapter 9.

- Develop interventions that specifically target export survival, enabling SMEs with the potential to sustain long-term exports to move beyond ad hoc, hit-and-run exporting and grow into the multiproduct, multimarket incumbents that most benefit LAC economies. By enhancing firms' odds of getting a return on internationalization investments, and by helping firms to formalize their learning-from-exporting process, such interventions could encourage more LAC SMEs to build the knowledge, capabilities, and relationships needed to pursue successive export initiatives. Interventions may also reduce the per-period fixed costs and successive entry costs and activities involved in export expansion, such as shipping requirements or compliance with trade rules. We turn to these latter challenges next.

## II. Trade Costs

In recent years, breakthroughs in technology and transportation have increased the cost effectiveness of international freight movements and international logistics. Shipping a can of Heineken beer from Holland to Hong Kong now costs only one cent despite its roundabout route through both the Mediterranean Sea and the Suez Canal!<sup>27</sup>

Yet despite advances, significant inefficiencies and waste remain in the area of activity often referred to as “trade costs.” While there are varying definitions of trade costs in the research literature, here we take a somewhat narrow view to include only the key factors affecting the costs of moving goods from factory to end market. These factors are transport infrastructure, and related services, primarily freight, and border administration, particularly customs procedures. We limit our discussion to these factors in part because even this rather narrow set of issues represents problems of tremendous scale. A World Economic Forum (WEF) study recently illustrated this fact. The WEF study showed that if all countries around the world were to bring their trade costs in these categories half-way up to global best practice, global exports would increase by \$1.6 trillion, or 14.5 percent. Within the region, the increase for Mexico would be 11.2 percent, for Brazil, 29.7 percent, and for the rest of LAC, 37.9 percent.<sup>28</sup> Meanwhile, also within the region, deficiencies in infrastructure, weak competition in shipping services, and red tape at customs are considered extremely troublesome and stand as the region's number one obstacle to trade at the present time.<sup>29</sup>

The foregoing makes it clear that trade costs are a well-known problem especially for LAC, leaving ample opportunity for improvement. A great deal of excellent work addresses the general topic of trade costs in the region and its many nuances.<sup>30</sup> Our purpose in this chapter is to focus on the implications of trade costs for LAC SMEs. In so doing, we hope to lay the foundation for thoughtful consideration of insights and actions that might loosen the chokehold specifically on SME internationalization.

Why is this focus important? The reason is because high trade costs affect SME internationalization by impeding both input access and market access. First, SMEs experience cost increases for, and decreased access to, the foreign inputs that SMEs need for further internationalization. Second, SMEs suffer a decrease in profit per unit of export sales, a hit that they are less able to withstand as a proportion of total profits than are large firms, and which make a greater number of export initiatives uneconomical.

The discussion is laid out as follows. Part one provides context, describing the determinants of customs and transportation costs and how firms generally respond to these costs. Part two addresses the several ways in which high trade costs are particularly burdensome for SMEs, including patterns and data specific to LAC SMEs. Part three assesses the state of trade costs in Latin America and their implications for the region's SMEs. The fourth part summarizes key insights and highlights directions for policy.

## ***A. The Role of Trade Costs in Internationalization***

### ***1. Key Determinants of Trade Costs***

In this discussion, we define trade costs as the costs of moving goods from the starting point (typically the factory) to the final destination. The main components of this movement include transportation and freight, and customs procedures and attendant documentation (Table 1).<sup>31</sup> While increases in the use of containerization and intermodalism have reduced some of these costs, many others remain onerous. The process can be particularly risky to the unaware or inexperienced exporter. For example, when a vessel is in danger, the ship's master has the right to sacrifice freight, and the steamship line may then spread the cost of the loss or expense across all freight onboard. Clearly, exporters need appropriate insurance to safeguard against such an incident. This is just one of many ways in which exporting logistics and shipping differ from domestic trade. Bottom line: moving goods

**TABLE 1/**  
**Determinants of**  
**Trade Costs**

<b>Transport infrastructure</b>	<b>Border administration</b>
<ul style="list-style-type: none"> <li>• Availability and quality of transport infrastructure</li> <li>• Availability and quality of transport services</li> <li>• Availability and use of information and communication technologies (e.g., tracking electronic tolls, communication)</li> </ul>	<ul style="list-style-type: none"> <li>• Efficiency of customs administration</li> <li>• Efficiency of import-export procedures (e.g., coordination between border agencies, administration burden of complying with standards)</li> <li>• Transparency of border administration (e.g., facilitation payments)</li> </ul>

*Sources:* Authors on the basis of World Economic Forum.

internationally entails an unusually high level of detail, complexity, uncertainty, and expense.

## **2. Effects on Firm Activity**

High trade costs affect a business in the following ways:

- Add to up-front capital expenditures (sunk entry costs per market), due to the need for personnel and capital to assess the costs and prepare systems to manage logistics.
- Add to operating costs (fixed per-period costs) as well as per-unit costs.
- Create unpredictable and/or longer delays in serving export markets.
- Increase risk.
- Force a firm to require a higher ROI from its exports initiatives to make up for the additional investments and uncertainty.

Individual firms typically respond to large trade costs by holding increased inventory as buffer stock and/or stock in transit. Although this compounds the expense, businesses take this measure to avoid perceived reputational damage among customers and channels that would result from late delivery or non-delivery, and/or to prevent opportunity costs in the form of lost revenues. In some situations, real risk transpires, whether in the loss of customers or channels, greater currency volatility due to longer holding periods, or lawsuits. More generally, distortions caused by high trade costs occur at multiple points in a firm's processes. For example, poorly maintained roadways reduce truck weight capacity speed, meaning that a given volume of units requires the use of more trucks than optimal because it costs more to maintain and repair the vehicles. Meanwhile, a poor rail network may force the use of long-haul trucks for goods that would otherwise be shipped via rail.



The academic literature shows that as trade costs fall, several patterns emerge.<sup>32</sup> At the firm level, non-exporters with relatively high productivity are more likely to start exporting; meanwhile, existing exporters will increase their shipments abroad. These two changes take place because the export initiative now demands relatively less up-front investment and/or because higher profits per unit are anticipated.

At the industry level, a strong decline in trade costs is associated with productivity growth. This results from a reallocation of activity towards more productive firms within the industry. Increased access to external markets combined with lower per-unit costs results in greater profits for exporters. In turn, the promise of solid export profits encourages higher productivity firms from the competitive fringe into the export market, which raises the productivity threshold for the entire industry and forces the least productive non-exporters to close. In an environment of declining trade costs,

### **Building upon the Inca Road Network in Peru: Improving Roads, Increasing Exports**

Between 2003 and 2010, more than 5,000 kilometers of new land routes were constructed in Peru, amounting to roughly a 14 percent net expansion of the country's main road network. The new roads were asymmetrically distributed: some routes from plants to ports of exit were reduced in length, while other routes remained the same length. This distribution pattern enabled researchers Carballo, Volpe, and Custolito to compare the effects of each of the two sets. Further, the spatial allocation of the new roadways was heavily influenced by historic precedent laid down by the Inca road network, and had little to do with current foreign trade considerations. As a result, the researchers could establish a one-way causal relationship between the new internal road infrastructure and firms' exports.

The results were both robust and substantial. The rate of growth of the value of exports carried on routes to the main port that experienced a reduction in their length due to new road construction was estimated to be almost 40 percent higher than that of exports transported on routes that remained the same length. Export quantity increased by 47 points, and the number of shipments went up by 24 percent. From the national perspective, total Peruvian exports in the absence of changes in the roads would have been roughly 20 percent smaller in 2010, which was the final year of the transport network expansion.

*Adapted from Carballo, Volpe Martincus, and Custolito (2013) "New roads to export: Insights from the Inca roads." VoxEU.org*

high-productivity firms are more likely to expand at the expense of low-productivity firms, which fail.

Trade cost barriers affect firms differently according to sector. For example, delays at the border matter far more to time-sensitive goods, making exporting more costly and risky for (say) a seller of fresh fish than a firm that sells canned fish. Inefficiency of import-export procedures also weigh heavily on highly regulated industries, such as chemicals and agricultural products. Product value is another key characteristic; in general, lower value products typically have higher relative logistics costs, and are thus hardest hit by these costs.

### ***B. How Size Matters in Considering Trade Costs***

High trade costs are particularly troublesome for SMEs. First, the same level of expense is more burdensome to an SME than to a large firm as a percentage of total profits. Second, many of the barriers creating trade costs also involve significant up-front investments, adding to sunk costs per market and hindering exports at relatively low scale. Third, few SMEs have the time and personnel (or capital to hire additional personnel) needed to manage the specifics of documentation, policies, regulations, and procedures of every country where they might do business.

Of the firms doing business on eBay, many of which are micro-enterprises, 97 percent with more than \$10,000 in annual sales sell goods internationally. A survey of eBay's small German SMEs showed that one-third of the significant barriers to exporting outside the EU have to do with regulatory regimes or with difficulties in international shipping. In response, the SMEs limit their sales to the countries whose regulations are easiest to navigate and whose shipping services are most reliable.

The biggest impact for SMEs selling on eBay is trade volume. eBay has worked with pre-selected SMEs in targeted pilot programs in which they remove key trade cost barriers, for example, by providing transparency on fully landed costs and delivery dates and by handling shipping. Based on pilot results, removing trade cost barriers expands international activity by small business sellers by an estimated 60–80 percent.<sup>33</sup>

Earlier we saw that as trade costs decline, high productivity non-exporters are drawn into exporting. This is also the case for SMEs. But when trade costs rise, SME exporters are hurt the most, and the smaller and lower-productivity exporters drop out of exporting. Even for firms that continue to sell internationally, the levels of export sales are reduced.<sup>34</sup>

It has been shown that when large firms are faced with increased transport costs they tend to substitute FDI investments (in-country production) for exports. This is a trade-off available to large firms: FDI, which involves a large capital expenditure, becomes a more economical way to maintain a relatively higher per-unit profit.<sup>35</sup> In contrast, due to capital constraints as well as the complexities involved in establishing and managing a foreign plant or subsidiary, the great majority of SMEs cannot activate such a Plan B.

Trade costs also help explain why the odds are stacked against LAC SME exporters attempting to expand sales beyond one or two international markets, despite the clear benefits of export diversification in terms

### **A Sudden Disruption at the Argentina-Uruguay Border: SME Exports Take a Dramatic Hit**

Three international bridges span the border between Argentina and Uruguay, and the main bridge carries nearly 50 percent of Argentine exports to Uruguay. Environmental protestors blocked this bridge and made it virtually unusable for approximately four months in 2005 and then for more than three consecutive years. Nearby customs clearance fell close to zero, indicating that goods were being rerouted and that firms that typically used this bridge were optimizing their shipments differently against the new parameters.

Using a firm-level dataset, researchers Volpe, Carballo, and Garcia analyzed the impact of the bridge closure in order to determine whether Argentine firms of different sizes reacted differently to the increase in trade costs triggered by the blockade. They found that while Argentine firms' exports to Uruguay were not substantially affected overall, the blockade did hurt exports of the smallest firms, across several measures.

These small SMEs (bottom 25<sup>th</sup> percentile of exporters by export value) saw a reduction in the number of shipments, the quantity shipped, and the number of products sold in the neighboring country. Depending on the sample period, the value of lost exports ranged from 44 percent to 72 percent. Further, Uruguay was the sole export destination for 56 percent of this group, meaning that a drop-off in these sales translated into a steep decline in total firm exports. Finally, it should be noted that these SMEs were often new exporters who averaged less than 2.5 years in foreign markets, not having yet made it through the first three years of export survival.

What drove these disparate reactions? Larger firms were able to withstand the bridge closure either by using more distant road crossings or by switching their mode of transport. In contrast, small SMEs were far less able to manage the increased costs, information requirements, and/or general complexity demanded by the disruption.

*Adapted from Volpe Martinus, Carballo, and Garcia (2011) "Bridges and Trade: Firm-level Evidence Based on a Natural Experiment." Inter-American Development Bank.*

of reduced risk, higher revenues, and greater growth potential. Assessing and selling into multiple foreign destinations is both costly and complex because of the lack of uniformity in custom rules as well as shipping and logistical procedures. A dearth of information on how these processes and costs vary from country to country further dissuades SMEs.

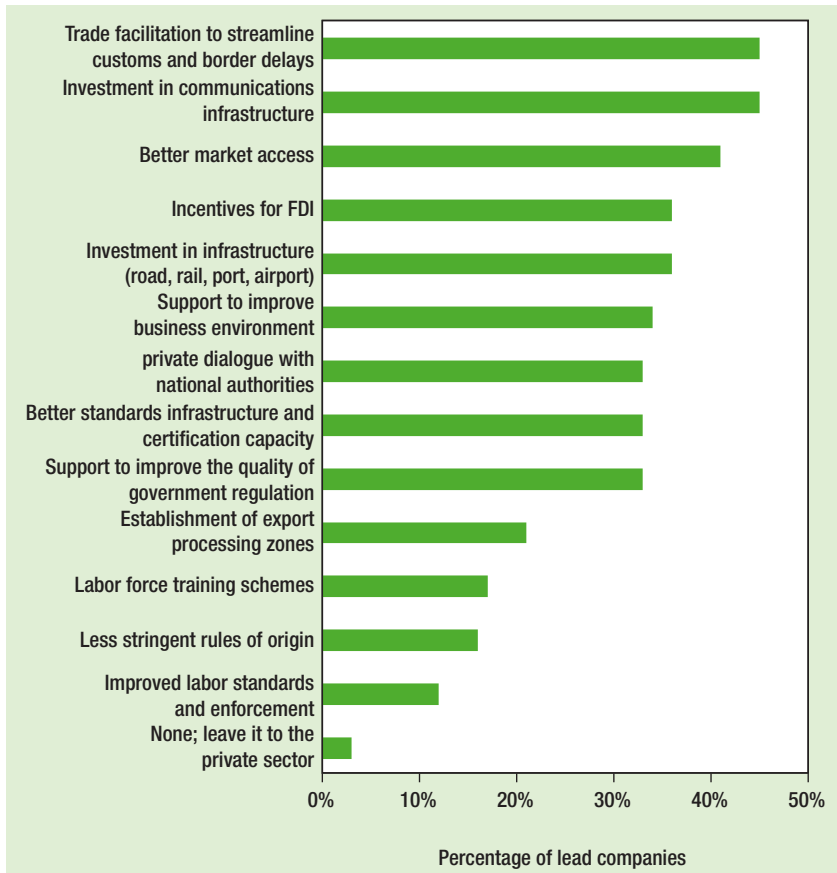
There are two additional modalities of SME internationalization impacted by trade costs that lend themselves to inter-regional and country-specific solutions.

The first pertains to the pricing of quality imports. SMEs that use foreign inputs tend to become more productive and gain a significant runway in internationalization. As we explored in Chapter 2, the use of imports often leads to exporting; foreign inputs tend to improve productivity at the firm level, expose firms to global best practices and standards, and allow for the creation of a network of foreign contacts and familiarity with international business cultures at the management level. Yet relatively high levels of trade costs significantly change the mix and pricing of imports. New costs may occur in multiple areas, such as managing customs documentation and in-country transport.

The second modality of internationalization for SMEs that can be severely affected by trade costs is insertion into global value chains. High trade costs can dissuade a multinational company from investing in a given country, and instead select other locations. This in turn reduces the number and variety of GVCs in which local SMEs may participate as suppliers. According to a recent OECD/WTO survey of 177 multinational companies spearheading GVCs, trade facilitation to streamline customs and border delays is the single most effective type of support for bringing new developing country suppliers into their value chains. Communications and transportation infrastructure are also among these lead companies' leading concerns (Figure 1).<sup>36</sup>

### **C. Regional Trade Costs: Priority Challenges for LAC SMEs**

How do trade costs affect LAC SMEs? A general review of the LAC region's trade costs reveals that there is work to be done. In the World Economic Forum's survey-based indexes of transport efficiency, LAC trails most of the world (including the OECD nations, ASEAN, Central and Eastern Europe, the Middle East, North Africa, and developing Asia) across several key measures. These measures include efficiency of customs administration, efficiency of import-export procedures, transport and communications infrastructure, and availability and quality of transport services. LAC also trails



**FIGURE 1/**  
Support Mechanisms that Lead Companies Find Most Effective to Bring Developing Country Suppliers into Value Chains

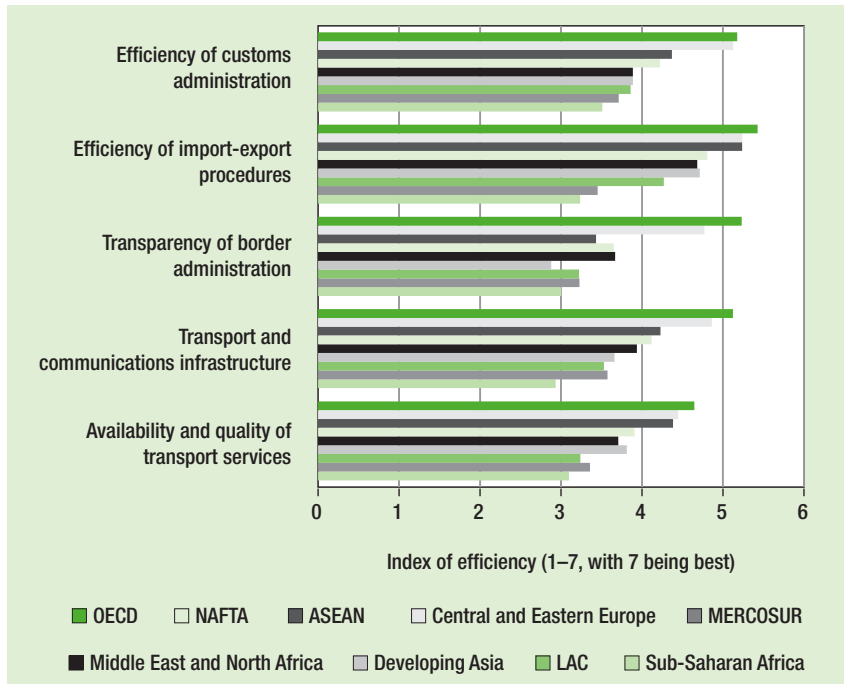
Source: OECD-WTO aid for trade monitoring survey: private sector questionnaire, 2013.

the OECD, ASEAN, Central and Eastern Europe, and the Middle East and North Africa, in transparency of border administration, exceeding only developing Asia and Sub-Saharan Africa (Figure 2).

Further analysis shows that these indicators matter a great deal, resulting in constraints to LAC SMEs in several areas. The following section highlights three such areas: customs clearance times, freight costs, and inland transport costs.

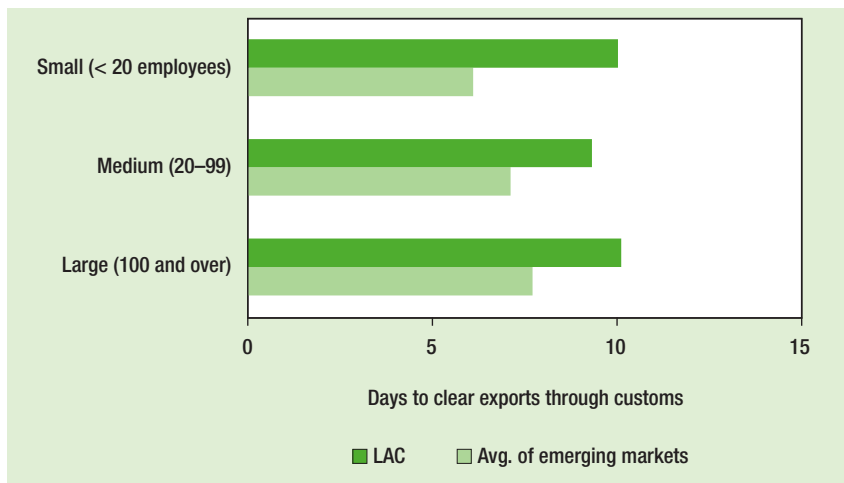
**Customs Clearance Times.** Compared to other developing regions, LAC SMEs report longer times to clear customs: some 9 days for exports and 13 days for imports, as opposed to 7 and 12 days, respectively, for other developing regions (Figures 3 and 4). LAC does particularly poorly vis-à-vis Eastern Europe, where customs clearance for exports and imports takes

**FIGURE 2/**  
Efficiency and Quality  
of Customs and  
Transportation, by  
Region (index of 1–7,  
with 7 being best)



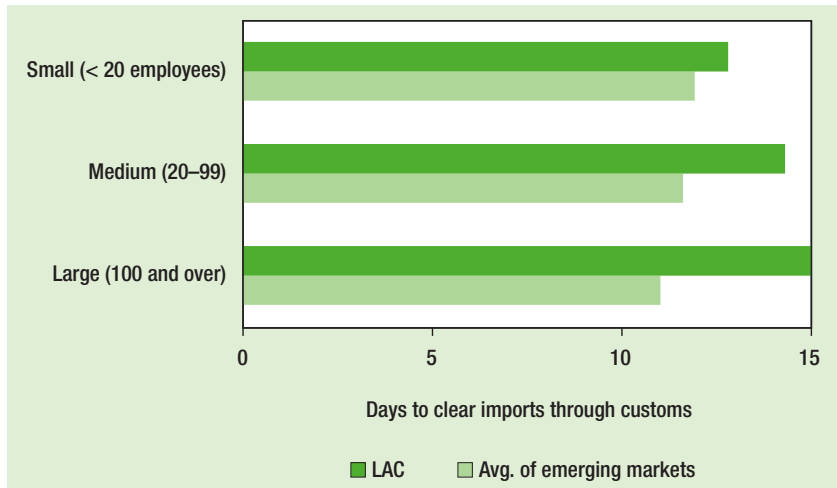
Source: World Economic Forum.

**FIGURE 3/**  
Customs Clearance  
Time for Exports,  
2006–2010



Source: World Economic Forum.

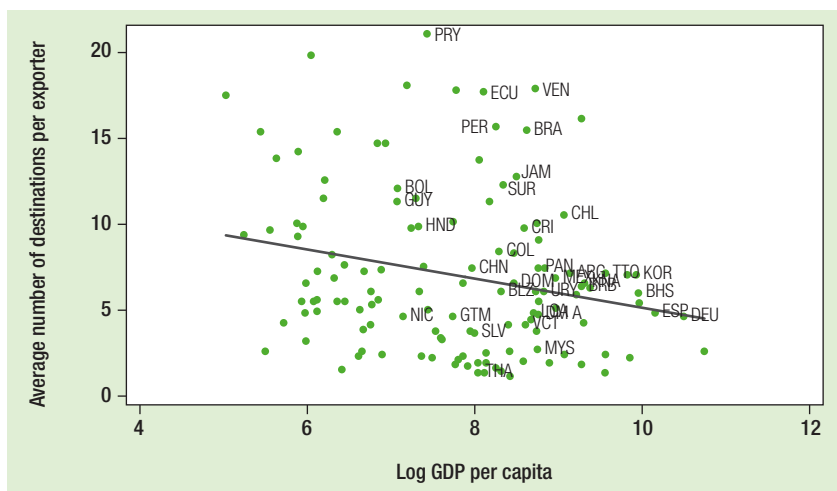
4 and 9 days, respectively. As a result, LAC SMEs suffer a significant cost disadvantage vis-à-vis emerging market competitors. Even a difference of a day can have serious consequences: each extra day a good is in transit is estimated to be the equivalent to 0.6–2.3 percent ad valorem tariff.<sup>37</sup>



**FIGURE 4/**  
Customs Clearance  
Time for Imports,  
2006–2010

Source: Authors' calculations based on Enterprise Surveys.

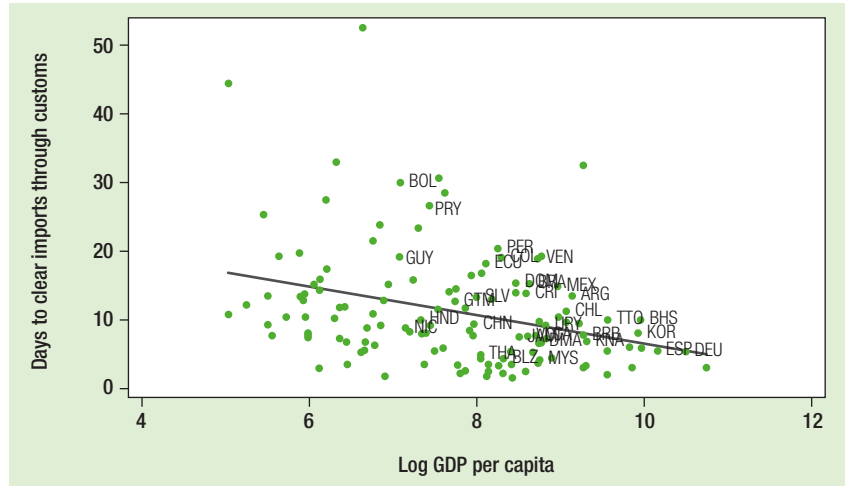
It also takes notably longer for LAC SME exporters to clear customs than for SME exporters in countries of comparable levels of development. Weighted data show that customs clearance for SME exporters in such countries as Paraguay, Ecuador, and Venezuela takes 18 to 22 days. This is fully 5 to 7.3 times longer than SMEs in Malaysia, where customs clearance requires just 3 days on average (Figure 5). This problem is mirrored in LAC SME importers, with land-locked Bolivia and Paraguay scoring particularly low against the global average (Figure 6).



**FIGURE 5/**  
Customs Clearance  
Time for SME Exports  
and GDP Per Capita,  
2006–2010

Source: Enterprise Surveys and World Development Indicators.

**FIGURE 6/**  
**Customs Clearance**  
**Time for SME Imports**  
**and GDP Per Capita,**  
**2006–2010**

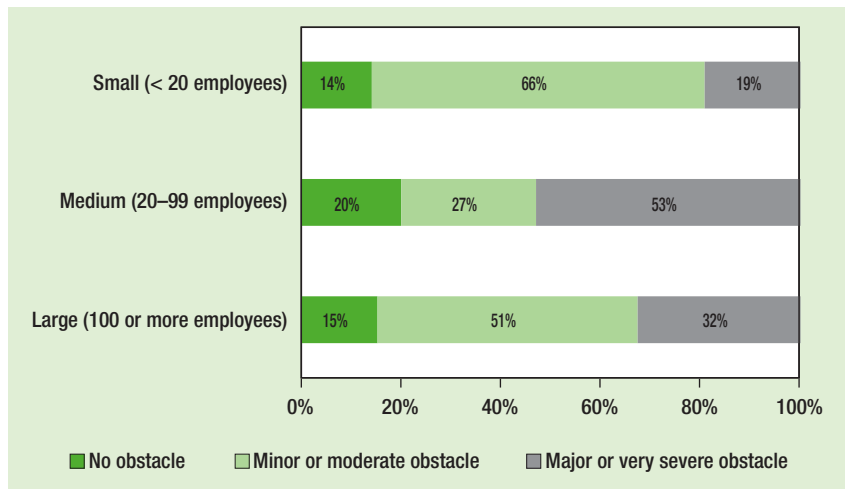


Source: Enterprise Surveys and World Development Indicators.

Fully 56 percent of LAC SME exporters report that customs and trade regulations pose an obstacle to their international trade activities.<sup>38</sup> Survey data by size of firm in Figure 7 show that the issues are most severe among medium-sized SMEs. This may indicate that large firms have greater resources to deal with the barriers, while exporting by smaller SMEs is more limited.

Despite the above conclusion regarding SMEs, a new detailed analysis of port of entry procedures in Peru illustrates the difficulties faced by small firms.<sup>39</sup> For a one-day increase in procedures, trade costs increase by about

**FIGURE 7/**  
**LAC SME Exporters’**  
**Reponses to Question,**  
**“How Much of**  
**an Obstacle Is**  
**Customs and Trade**  
**Regulations?” by Firm**  
**Size, 2009–2010**



Source: Authors’ calculations based on Enterprise Surveys.



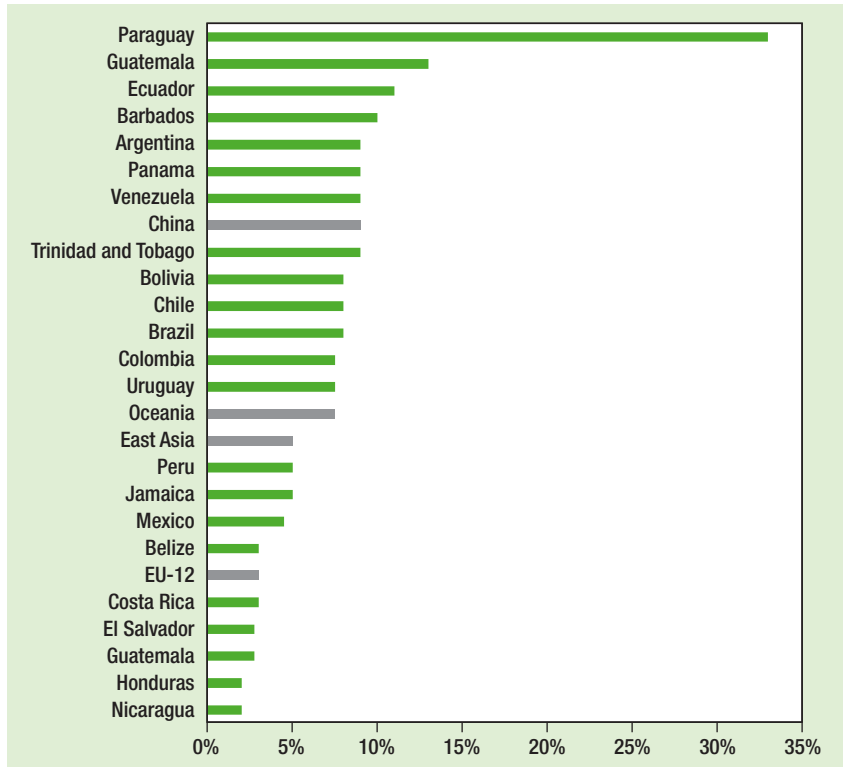
0.8 percent. The average delay due to entry procedures is about 8.5 days, which translates into an 8.5 percent increase in trade costs for the average import. Small firms and large firms tend to pay the greatest costs resulting from delays due to entry procedures. However, the summary statistics show that large firms can compensate for some of this. According to the summary statistics, larger importers are processed on average 4 days faster than small importers. This suggests that small firms incur the highest costs from port of entry delays because their trade cost is most sensitive to delays, and they experience the longest delays at the port of entry.

**High Freight Costs.** Elevated freight costs can render SME exports uncompetitive or deter SMEs from exporting altogether. Many Latin American and Caribbean countries enjoy proximity to the world's single largest market, the US. Yet this proximity does not always translate into lower freight rates. Take ocean freight for manufactured products as an example. Most LAC countries have higher freight rates (as share of the export value) than countries in the Far East and in Europe (Figure 8), even though these regions are farther from the US than most LAC economies.<sup>40</sup> While most of Central America and some countries in the Caribbean are at the low end of the rate spectrum, even their rates do not differ much from those of the EU-12 or East Asia. At the higher end is most of South America, but also some Caribbean countries. Though China is farther from the United States (about 7,000 miles away) than Argentina (about 5,000 miles away), its freight costs are still lower than those faced by Argentina's manufacturers.

The lack of correlation between LAC's proximity and its freight rates for air freight (which includes both agricultural and manufactured goods) is even starker (Figure 9). However, securing lower freight costs is no easy feat, as the case study on Colombian flower exporters illustrates.

There are a number of drivers behind these challenges. Figure 10 decomposes the determinants of ocean freight rates in LAC vis-à-vis the Netherlands, which is one of the best performers in the world in terms of freight and transport.<sup>41</sup> For US-bound exports, LAC has 172 percent higher ocean freight costs than does the Netherlands. The figure shows that the main factor explaining this difference is the weight-to-value ratio. This is almost entirely due to differences between LAC and the Netherlands in the composition of the baskets of goods that are exported: LAC ships heavier items, which is another key reason why trade costs are so critical to LAC economies.

**FIGURE 8/**  
**Ocean Freight**  
**Expenditures as a**  
**Share of Export Value**  
**to the US, LAC and**  
**Selected Regions in**  
**Manufactured Goods,**  
**2006**

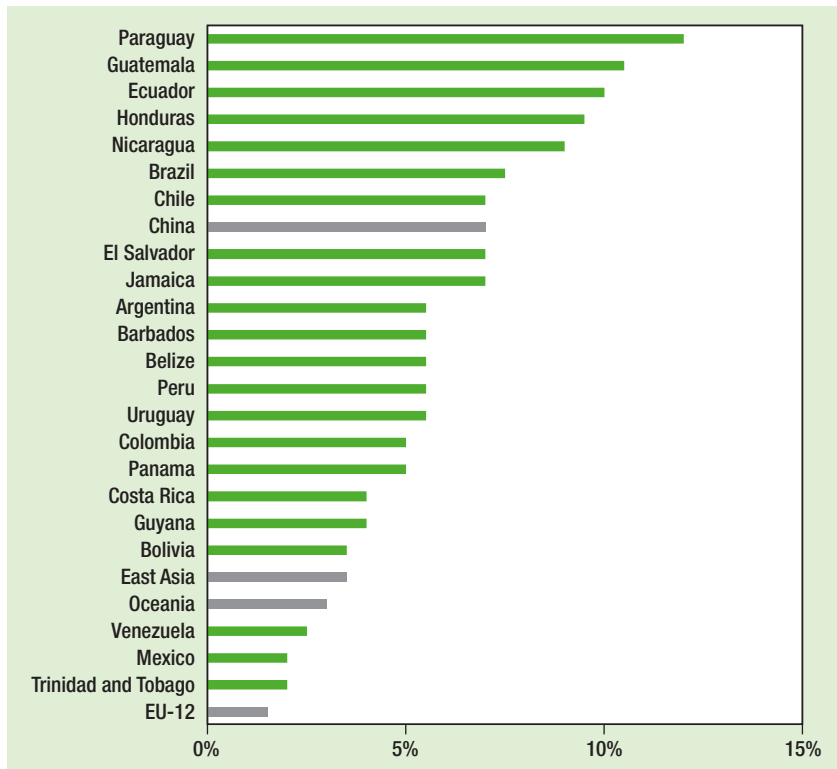


Source: Moreira et al., (2008) *Unclogging the Arteries: The Impact of Transport Costs on Latin America and Caribbean Trade*.

Further factors that raise LAC transport costs above those of the Dutch are port efficiency, followed by the level of competition among shipping companies (proxied by the number of shippers) and, to a lesser degree, the overall trade volume. Meanwhile, differences in the level of containerization and in demand elasticity have an almost imperceptible role in explaining differences in the shipping costs.

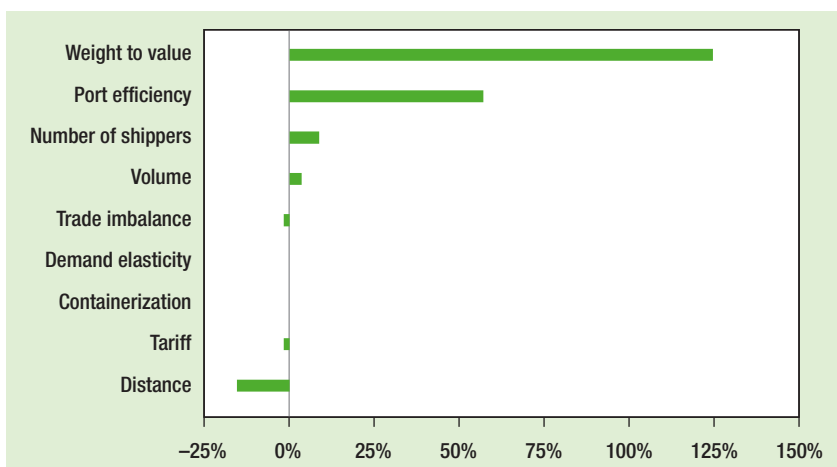
In sum, LAC and LAC SMEs face a significantly less advantageous freight cost structure than their global competitors. This obstacle to trade can be reduced through improved port efficiency, greater competition among shippers, and, in particular, export diversification into less bulky products with a lower weight-to-value.

**High Inland Trade Costs.** Not all LAC SMEs are near the ports and airports needed to ship their products; many SMEs must make a long inland journey to reach the export port. In a region with a transport infrastructure



**FIGURE 9/**  
Air Freight Expenditures  
as a Share of Export  
Value to the US, LAC  
and Selected Regions,  
2006

Source: Moreira et al., (2008) *Unlogging the Arteries: The Impact of Transport Costs on Latin America and Caribbean Trade*.



**FIGURE 10/**  
Determinants of the  
172% Difference in  
Ocean Freight Rates  
between LAC and the  
Netherlands in Exports  
to the United States,  
2000-05

Source: Authors' calculations based on Moreira et al. (2008) *Unlogging the Arteries: The Impact of Transport Costs on Latin America and Caribbean Trade*.

### Overcoming Prohibitive Trade Costs: Collaboration in the Colombian Flower Sector

Transportation issues made the early years of Colombian flower exporting difficult for the largest of firms—and impossible for smaller growers. After numerous fits and starts, the problems were solved through joint efforts by the flower exporters, the Colombian Association of Flower exporters (Asolcolflores), and the Colombian government.

In the early 1970s, the country's flower growers had made great progress in controlling plant diseases and standardizing production techniques. But they faced extremely high costs and erratic logistics in getting their product to overseas markets.

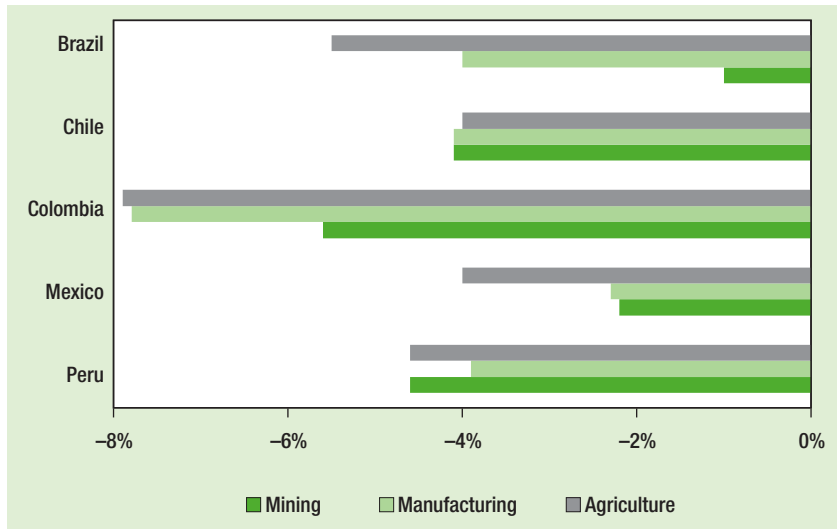
At the time, Colombia had only a few airlines. There were few flights to the US and no direct flights to Europe. The largest market leaders first attempted to transport their flowers themselves, but this ended in financial difficulties and a disruptive plane crash. In addition, despite their appeal to the Colombian carriers to give special handling to their products, their requests went unheeded. The flowers were shipped as part of the regular passenger luggage on regularly scheduled flights. Moreover, the narrow doors on the aircraft required that the flowers be loaded manually, which added further to already exorbitant expenses. It appeared that the situation would improve when the top Colombian carriers Avianca and Sam agreed to enter the business of shipping flowers, at night and with new logistics support. But another plane crash stopped this plan cold.

The industry association Asolcolflores then decided to hire a charter from Ecuador. The association brokered agreement among a number of exporters, each of whom would send a certain number of flower boxes. This marked a turning point in overcoming the entry barrier by establishing a transportation system that would open up the market potential in mass quantities. Success bred competition and selection, as US-based carriers such as Frontier, Challenger and Florida West flew to Colombia to transport flowers to the US.

Shipping flowers to Europe required another collaborative solution. At first, a group of exporters, with government assistance, contacted German carrier Lufthansa. But the DC-10 used was too wide to reach the international gate at the Bogota airport. Avianca then brought in a more appropriate alternative, a 747 to support the flower growers. The government again stepped in, and the director of Aerocivil facilitated a connection between Asolcolflores and several exporters on the one hand, and Spain's Iberia airline on the other. This initiative led to the use of a targeted freighter for the purpose of shipping Colombian flowers to Spain.

Only more reliable, secure, and cost-effective shipping alternatives could make it possible for the majority of Colombia's flower growers to export, thus spurring the overall sector's development. Nonetheless, even today this sector faces high per-period and per-unit costs related to its ongoing transportation needs.

*Adapted from Arbeláez, Meléndez and Meléndez "The Emergence of Fresh Cut-Flower Exports in Colombia" pp. 69–100, Export Pioneers in Latin America (2012) edited by Sabel et al., IDB.*



**FIGURE 11/**  
The Impact of Transport  
Costs on Exports by  
Sector and Country

Source: Moreira et al. (2013) *Too Far to Export: Domestic Transport Costs and Regional Export Disparities in Latin America and the Caribbean*.

deficit, great continental distances, and challenging terrain, inland transport will quickly add to LAC SMEs' trade costs. Recent research by the Inter-American Development Bank finds that most LAC exports tend to originate from regions where trade costs are lowest, and this accentuates disparities between firms in these regions and those near export ports.<sup>42</sup> For example, northeast Brazil and southern Mexico export relatively little, in part due to their deficient infrastructures and distance to main ports and foreign markets; transport costs price these regions' products out of the market. The main economies all experience lower exports across sectors due to high domestic transport costs, with Colombia having as much as 8 percent to gain in exports from improvements (Figure 11).

#### **D. Conclusions and Policy Implications**

Trade costs—defined here as bottlenecks in border administration and transport infrastructure and logistics—significantly impact internationalization of firms. Due to onerous trade costs, companies invest more at the onset of an export initiative, receive lower per-unit profits, hold greater inventories, and bear greater risk. Trade costs also affect firms differently by sector. Particularly affected are firms that export time-sensitive and lower-value goods and operate in heavily regulated industries. Measures to reduce trade costs have had enormous benefits on trade. For example, new roads that connected to

ports of exit increased Peru's exports by value (increase of almost 40 percent), quantity (47 percent) and number of shipments (24 percent).

These effects are magnified for smaller firms, which are particularly hurt by high trade costs in at least four ways, as follows:

- SMEs face significant difficulties due to the lack of up-front investment needed to cover trade costs, the reduction of profit per export initiative and per unit of export sale, and the insufficient managerial capacity needed to manage logistics and documentation.
- High trade costs further diminish the use and/or increase the cost of quality foreign inputs, which otherwise function as an important step in LAC SME internationalization.
- High trade costs in certain markets limit SMEs to selling into foreign destinations where regulations are easy to navigate and shipping services are known for their reliability, but which might not necessarily be the best match for their products and capabilities. The variation in trade costs from destination to destination also means that SMEs are ill-equipped to expand to more than one or two export markets.
- High trade costs also dissuade multinational companies from investing in a country, thus constraining opportunities for local SMEs to become their suppliers.

This suggests that measures to reduce trade costs could provide disproportionately large gains to LAC firms, and to LAC SMEs in particular. The question is how best to put these measures in place. We have presented evidence of trade costs in LAC that are bound to affect SMEs. These include customs clearance times, high ocean and air freight rates, and elevated inland transport costs. Some of the challenges that compound LAC transport costs are the regional products' high weight-to-value ratio and limited competition among the regional shippers.

This review is far from exhaustive. For example, another area that could be analyzed is movements of goods in LAC ports. Another is the impact of different sources of trade costs on LAC SMEs. Thus far, we know a few separate data points. For example, several studies indicate the key importance of transportation infrastructure. From our analysis of the Enterprise Surveys, it appears that customs clearance times are a significant problem, especially for midsize LAC SMEs. Inland transport costs doubtless matter to SMEs located far from export routes and ports. Additional critical issues, according to the

eBay research on German SMEs, are the number of regulatory regimes and difficulties in international shipping.

Diagnostic and policy analyses are currently examining the impact of broad reforms on the region's trade costs in areas such as security, connectivity, services, and more. Clearly, such reforms would benefit all LAC companies, including SMEs. Additional priority directions for policy interventions with the potential to assist LAC SMEs include the following:

- **Clarify and prioritize the importance to SMEs of trade facilitation.** A first step would be to understand precisely which barriers most influence SME internationalization and at which stage of the process; and second would be to address these issues and perspectives in policy development. Given the evidence that market dynamics, including competition among shippers, impact LAC trade costs, one important area for study would be the cost-effectiveness of support services available to internationalizing SMEs. Such a study could be followed by investments and policy reforms to bridge gaps in quality and access. For example, increased access to international logistics and shipping by LAC SMEs, and use of specialists in this regard, could reduce the need for SMEs to understand, compare, and manage cumbersome documentation, shipping, and other critical procedures.
- **Develop a regional repository of accessible information on factors that contribute to trade costs in key LAC export markets and for major LAC export sectors.** Such a regional facility would enable LAC SMEs to quickly identify, compare, and quantify critical issues related to customs, transportation, and trade compliance. A model would be Colombia's PROEXPORT, which offers exporters a transport cost simulator. Rather than each LAC SME separately analyzing these issues for exporting to each individual destination, the region's economies could establish a single information portal in easy-to-use language and useful to all SMEs. It would also build upon and help pool the separate regional and national efforts already under way.
- **Help LAC SMEs to coordinate shipments.** Public policy can support LAC SMEs to pool their efforts in bargaining with shippers, making shipments, and carrying out other collective ways to lower trade costs. Such moves to widen the options for moving goods to market could be based on the use of technological platforms that enable SMEs to coordinate with each other to manage shipments. Shipping companies

themselves may be interested in such an initiative if it were to reduce marketing expenses, lower the actual shipping costs, and help develop business among the region's SMEs. In addition, opening the regional shipping industry to foreign participation should also be considered if foreign operations are presently subject to regulatory barriers.

- **Reduce trade cost barriers critical to multinational companies for deciding where to locate operations.** Locations near SMEs would increase opportunities for small firms to participate in global value chains. Such barriers include cumbersome customs procedures and border delays, deficient transportation and communications infrastructures, and overall market access.

### III. Trade Compliance

Trade integration and liberalization pursued by LAC economies in the past two decades have opened world markets to the regional SMEs by providing deep preferential access to some of the largest economies and allowing access to high-quality foreign inputs at world prices. Trade integration has also improved the region's access to foreign investment, propelled trade in services, and furthered trade facilitation. The result has been to reduce economic instability and generate growth in the region.

This state of affairs is vastly different from that of the 1980s, when most LAC economies were still highly protected. Yet paradoxically, LAC SMEs struggle to take advantage of this favorable environment, in part due to their difficulties in complying with the various international trade rules, regulations, and standards. There are compliance challenges in two principal areas: first, the various rules embedded in the numerous regional trade agreements (RTAs) which LAC countries have forged in the past two decades; and second, the so-called "behind-the-border" regulations and standards imposed by LAC trade partners, which consist of both public and private standards in response to consumer concerns about product safety, food quality, and sustainability. These rules can be especially taxing on SMEs, as smaller firms rarely have the depth and breadth of technical expertise in trade compliance as do large multinational companies.

The discussion that follows analyzes these challenges. The first part assesses the impact of complicated RTA rules on SMEs' use of RTA preferences. The second part reviews the challenges posed by standards. The third part lays out policy conclusions.



## A. LAC SMEs' Underused Advantage: Regional Trade Agreements

### 1. Complying with Complex Rules of Origin

LAC economies have been among the key actors in the global spree to form RTAs.<sup>43</sup> Over the past two decades, the region's economies have formed no fewer than four dozen intra- and extra-regional RTAs with such partners as the US, European Union, Korea, Japan, and China. While the region's trade per se has surged in importance in the past two decades, so has the relevance of RTAs in the trade of LAC economies. For instance, imports from RTA partners as a share of total imports is 94 percent for Chile, 73 percent for Costa Rica, and 70 percent for Mexico. Trade deals, in short, are a big deal in the region.

Despite the massive network of trade agreements that Latin American nations have formed, qualifying for RTA preferences can be an onerous task for the regional SMEs, particularly because of complicated product-specific rules of origin. Consider a number of challenges:

- A product's rule of origin can be expressed in complicated technical terms that are hard for an SME to decipher. Complex rules can deter an SME from utilizing RTA preferences, and certainly make it hard for the SME to calculate the costs of compliance.
- While electronic certification of origin is by now a widespread practice in the LAC region, firms must have sufficient capacity to fill out the forms correctly. The paperwork required in meeting rules of origin has its own costs. For example, in NAFTA, these costs are estimated at 1 percent of US import value in Canada and nearly 2 percent in Mexico.<sup>44</sup> When passed to the consumer, these costs place the region's SMEs at a competitive disadvantage.
- LAC SMEs are heavy users of foreign inputs. More than 70 percent of LAC SMEs and over 80 percent of LAC SME exporters use foreign inputs in their production, and in most countries at least a third of inputs used by firms in their production are of foreign origin. If the rule of origin in the SME's product is too "tight"—that is, if it requires that a high share of the export product's value arises from within the RTA area—SMEs that depend heavily on inputs from extra-RTA sources will be hard-pressed to meet the rule of origin and qualify for the RTA preference.

The compliance costs of rules of origin can become so high that the SME ceases to seek preferential treatment. Instead, the SME either exports to

the RTA partner by not taking advantage of the RTA preferences (i.e., paying the partner country's nonpreferential, most-favored-nation (MFN) tariff), or it chooses to forgo exporting to the RTA partner altogether.

This is a lost opportunity, particularly in product categories with a high preference margin—that is, where large differences exist between the (lower) RTA tariff and (higher) MFN tariff, and where the RTA thus provides the SME an edge against extra-regional rivals. This is typically the case in more protected sectors such as agriculture, food processing, textiles and apparel, and vehicles. In these categories, exporters able to take advantage of the RTA tariff liberalization have a significant edge over extra-regional firms that have to pay the elevated MFN tariff.

However, these are the very sectors in which rules of origin tend to be most restrictive and difficult to meet.<sup>45</sup> This is not surprising. Like tariffs, rules of origin are subject to politics. Protectionist interests are bound to lobby for stringent rules of origin when the RTA is negotiated. As tariffs are abolished, protectionist interests call for stringent rules of origin to substitute for tariff protection.

To be sure, rules of origin are not the only challenge facing SMEs seeking to take advantage of RTAs. An SME may face similar challenges in meeting stringent sanitary and phytosanitary standards or other technical norms as specified in the RTA. Should the compliance costs posed by such rules be too high, the SME would be unlikely to seek to take advantage of the new, hard-won RTA.

To what extent do complicated rules and procedural requirements undermine SMEs' utilization of RTA preferences? Preference utilization in RTAs is widely researched, perhaps particularly intensely in studies on US and EU unilateral preference programs. Utilization is generally found to be disappointingly low among developing countries, particularly in sectors with complicated and stringent rules of origin. The typical average overall compliance costs are estimated to be as high as 2–6 percent of the value of the shipped product. One rigorous study found that the preference margin should be as high as 10 percent so as to compensate for the costs of meeting NAFTA's value content rules of origin.<sup>46</sup>

A recent study on US, EU, Australian, and Canadian preferences finds that utilization increases with the preferential margin. This is not surprising given that a wide preferential margin provides significant cost advantages for those able to qualify for the preference. In addition, preference utilization has an important fixed cost element of up to \$1,500 per export

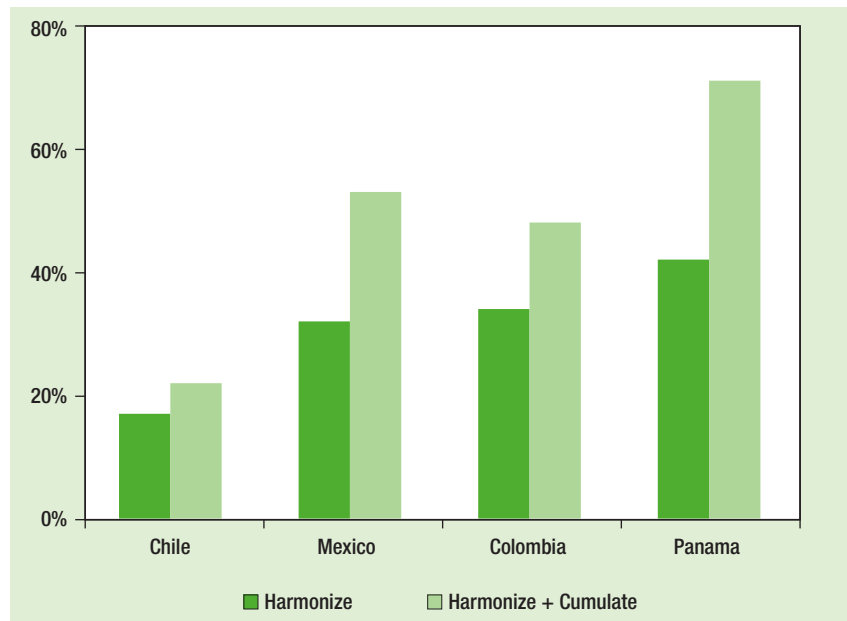
transaction. These costs are incurred for different reasons, including the need to regularly obtain a certificate of origin as well as changes to production processes to enable compliance. While research remains to be done on the utilization of preferences by firm size, these findings indicate that the costs involved in utilization place smaller exporters at a disadvantage.<sup>47</sup> Besides, the studies do not include firms that may have been deterred from using preferences altogether due to complicated rules of origin or other compliance costs.<sup>48</sup>

## ***2. Entangled in the RTA Spaghetti***

A broader challenge that RTAs pose to LAC SMEs is the “spaghetti bowl” of multiple overlapping RTAs. While highly beneficial for LAC firms in principle, multiple RTAs can also create transaction costs to firms seeking to simultaneously sell in various RTA theaters above and beyond what such costs would be if operating under one single set of trade rules. Even though there are certain RTA families such as US trade agreements, each new RTA even within these families has at least somewhat idiosyncratic market access rules and rules of origin regimes.

If required to meet a different set of market access requirements in each RTA, SMEs can be deterred from diversifying their export markets, or incur new costs to meet the rules of origin and other requirements specific to each RTA. This is especially the case if the rules of origin in these further RTAs would require the SME to change its sourcing patterns or production processes. A survey by the Inter-American Development Bank found that more than 20 percent of Chilean firms, one-half of Mexican and Colombian firms, and three-quarters of Panamanian firms (most of them SMEs) anticipate high or very high savings from harmonizing rules of origin and permitting cumulation of production across these countries’ various RTAs (Figure 12).<sup>49</sup> In this regard, one of the core purposes of the five-country Pacific Alliance in Latin America is to “converge” the member countries’ several bilateral RTAs into a single agreement, with a single set of rules of origin. The alliance has accomplished this by starting rules of origin (RoO) negotiations from scratch, rather than seeking to harmonize the existing RoO regimes in the bilateral agreements. The results of this new initiative remain to be gauged. However, the depth and speed of liberalization and rule harmonization that the members have already accomplished is highly promising for intra-regional trade and SME exports in the region.

**FIGURE 12/**  
**Percentage of LAC**  
**Firms that Agree**  
**with the Statement:**  
**“Savings from**  
**Harmonizing RTAs and**  
**Permitting Cumulation**  
**Across Them Would Be**  
**High or Very High”**



Source: IDB (2009).

## B. Proliferating Standards

### 1. Drivers of Standards

In addition to the proliferation of trade rules in RTAs, recent years have seen the spread of standards in international trade. As with the criteria to qualify for rules of origin, standards often vary from country to country. Demanding standards in an overseas market can act as a barrier to trade and curtail LAC SMEs' market access. Similarly, tough quality standards imposed by multinational companies on SME suppliers can stymie LAC SMEs' access to global value chains.

The proliferation of standards has been especially intensive for products in sensitive sectors such as food and agribusiness, which are of critical importance to LAC SMEs. Across industries, any one product may be subject to standards on a multitude of levels: technical regulations, packaging/labeling standards, process standards, product characteristics and quality, and match of shipment contents against orders. Entirely new and often ambiguous frontiers are opening up concerning environmental impacts and social accountability of production, among them, labor conditions, water conservation, and cradle-to-grave carbon footprint.

SMEs from developing economies often face particular difficulties in complying with the trade-related safety and quality standards. Among other reasons, this is because these SMEs tend to lack the capacity to identify, understand, comply with, and provide proof of compliance with numerous standards. Furthermore, standardization is a long-term process, requiring investment prior to benefits followed by continual upgrading and tracing, all of which is conditional on management's understanding of what their company stands to gain. The challenges posed by standards thus span several of the constraints to internationalization discussed in this chapter, including sunk costs, information barriers, intra-firm capabilities, and capital constraints.

Standards tend to fall into two broad categories: safety and quality. While safety is the focus of numerous formal standards at the international and national levels, the issue of quality cannot be overlooked. Empirical results by Juan Carlos Hallak, based on analysis of 1995 data on sectoral trends among 60 countries, confirm the widely accepted theoretical proposition that rich countries tend to import relatively more from countries that produce with high quality offerings.<sup>50</sup>

Yet the very concepts of safety and quality have become increasingly complex. First, quite a host of public and private sector actors are involved in the development, dissemination, and regulation of standards. Second, in contrast to the mandatory standards developed by recognized regulatory and legal bodies, the vast majority of trade-related standards is now voluntary; they are offered for adoption by individual companies or industry coalitions, but lack any legal requirement to be implemented. The fact that they are voluntary does not negate their enormous impact on an SME's opportunity to export into a market. Within Europe, for example, while all standards are voluntary, the majority of these are considered to be *de facto* mandatory, as they are the primary route through which manufacturers can demonstrate that their products comply with legal requirements. Other voluntary standards involve interoperability, meaning the ability of a product to function correctly together with other components and products in a larger system.<sup>51</sup>

Voluntary standards are especially powerful when they have been adopted across an entire industry as a signal of quality. Within the agricultural and food sectors, a plethora of private standards are now considered to be the primary drivers of agrifood production patterns and export behaviors on a global scale. These standards originate with many different players,

ranging from major food retailers and global restaurant chains to food manufacturers and large-scale processing firms. Further, they continue to evolve at a rapid rate in response to regulatory developments. They serve as a means of filling gaps in public standards on especially risky foods, and of managing liability. In addition, such voluntary standards drive competitive positioning and differentiation, for example, in the areas of organic production and animal welfare. As a result, SMEs in agribusiness face interlocking standards and multi-tiered systems of certification and accreditation.<sup>52</sup>

An announcement on January 7, 2014, by McDonald's illustrates the speed of change, the vast scope, and the complexity that characterizes contemporary global food standards. In response to demands from international environmental and animal welfare groups, the company stated that it will begin purchasing verified sustainable beef in 2016 as the first step towards using sustainable beef for all the burgers it sells worldwide. (Previously, in the 1980s, the company had stopped purchasing beef raised in the Amazon biome.) Yet as of the company's announcement date, volume requirements for 2016 or any year thereafter were as yet undetermined, creating uncertainty among suppliers. Even the standards had not been agreed upon, and discussions continue with the Global Roundtable for Sustainable Beef, a multi-stakeholder coalition, on more than a dozen issues impacting people, communities, animals, and the environment.

This latest corporate mandate joins several others at McDonald's regarding coffee, palm oil, poultry, fish, and packaging. Certification for each of these items is the responsibility of one or more associations, each separate from McDonald's and each with its own procedures and requirements. McDonald's buys its beef supply directly from about 20 processors worldwide, meaning that a single hamburger patty can contain meat from multiple cattle originating at multiple farms from different continents and raised on different diets. Clearly, verification and traceability will become high priorities in the beef supply chain.<sup>53</sup>

## ***2. Impact of Standards on LAC SMEs***

The impact of the proliferation of standards on LAC SMEs has been complex. Again, consider the food sector. On the one hand, small producers in the food chain lack comprehensive information and face huge up-front cost requirements. On the other hand, the large food companies find that there are simply not enough producers with the capacity to meet standards at volume. As a result, LAC SMEs that engage with food multinationals as preferred

suppliers often receive technical and capital assistance to build both assets and scale, while (typically small) producers outside this system fall farther behind in competitiveness and business sustainability.<sup>54</sup>

Across sectors, LAC SMEs are doubly burdened by standards, first, because they are small, and second, because they are from developing economies. In particular, LAC SMEs are disadvantaged by the following:

- **Lack of awareness and information for assessment.** LAC SMEs may now know that standards specific to their industry and products exist. They may have problems finding the relevant standards, understanding the detailed requirements, determining which standards are still in effect, or forecasting how standards will change in the future. They may be confused about how to demonstrate compliance, and which bodies, if any, are involved in the various certification, measurement and inspection processes.<sup>55</sup> According to a 2006 OECD/APEC survey on perceptions of obstacles to SME trade, policymakers ranked “restrictive health, safety and technical standards” in the top 25<sup>th</sup> percentile (11<sup>th</sup>) among 45 barriers. Meanwhile, the issue came in as 37<sup>th</sup> among SMEs.<sup>56</sup> The discrepancy further highlights the dearth of awareness among SMEs concerning the role that standards play in order to internationalize.
- **Lack of resources and capabilities for compliance.** Complying with standards requires a host of investments, among them, certification, auditing, product testing, and product redesign. In addition, they incur increased short-run production costs due to additional labor and capital associated with the prior steps.<sup>57</sup> LAC SMEs are short on the financial, technical, organizational, and human capital resources needed to formulate and execute these activities.
- **Lower domestic standards.** Domestic standards in developing nations often lag behind the international norm due to weak capacities in standards development and dissemination, metrology, product testing, laboratory accreditation, calibration, auditing, and so on. Weak points may also arise in the private sector value chain, as illustrated by sub-standard hygiene conditions for fish in processing facilities and on vessels. LAC SMEs simply start from farther behind than developed country SMEs in meeting standards required for successful exporting. The issue is compounded by the fact that foreign export destinations may not recognize LAC countries’ standards as sufficient. Meanwhile,

SMEs in advanced countries do qualify because their standards regimes are deemed stronger.<sup>58</sup>

SMEs that succeed in grasping and responding to relevant standards not only secure market access. They are also able to transform this potential barrier into an enabler of trade and competitiveness in at least four ways:<sup>59</sup>

- Standards support the dissemination of innovation by codifying cutting-edge knowledge; SMEs that meet these same standards are often able to strengthen their technical capacity.
- New standardization methods focus on management systems, meaning that their use can help SMEs build capabilities to move into new areas.
- Standards provide a guidepost for SMEs to focus limited resources on priority product and production improvements.
- Standards serve as a signal in the face of information asymmetries between supply and demand, leveling the playing field against better-known and often larger competitors, and reassuring business partners and customers alike of product quality and safety levels.

The Box below describes the successful compliance with standards among Mexican aerospace suppliers. Finally, meeting standards is not only an enabler of market access for, and market confidence in, the individual SME and its products or services. It also has the potential to generate two types of spillovers, first by educating other local SMEs about standardization, and second, in boosting a reputation for safe, high-performing products at the country-sector level in key export markets.

### **C. Policy Conclusions**

LAC SMEs poised to internationalize potentially stand to gain from trade liberalization and the dozens of RTAs that LAC countries have struck over the past two decades. Yet they are hard-pressed to meet the various regulations and standards necessary for gaining market access and, in the case of RTAs, utilizing the often deep tariff preferences RTAs confer. From the policy perspective, these findings indicate the need for various policy interventions aimed directly at SMEs. Included are the following:

- **Develop pilot programs to fill the information gaps facing SMEs on the plethora of rules and standards relevant to key subsectors and**



### **Mexico Boosts Aerospace Exports and the Fortunes of a Small-scale Textile Producer**

The global civil aerospace market totaled nearly \$300 billion in 2012, a 4 percent increase over 2011 levels. The 287 aerospace companies that make up Mexico's aerospace industry account for a significant share of that total. In 2012 alone, these companies exported \$5.4 billion in aerospace goods and related services, which represents more than a 40 percent increase over the last half-decade.

That success has been driven by three factors: a well-trained, technically proficient, and cost-competitive workforce; a rapidly growing supply of engineering expertise (Mexico graduated more engineers than Germany in 2012); and proximity to the most established aerospace markets in the world (the US, Canada, and Brazil). Those factors, combined with the Mexican government's long term, integrated strategy to promote the aerospace sector, ensured that Mexico would attract the most foreign direct investment in aerospace of any country for the fourth consecutive year in 2012, a total of \$1.3 billion.

An example of that trend was the Canadian firm Bombardier's decision to expand its operations in Querétaro, the principal hub of the Mexican industry. Bombardier intends to carry out all structural work and a share of the assembly work on the latest model in its Learjet line, the Learjet 85 business jet, which will reach world markets by the end of 2014.

In addition to Querétaro, Mexico's aerospace industry consists of four other clusters in the states of Nuevo Leon, Chihuahua, Sonora, and Baja California. Only five years ago, the industry consisted of 150 aerospace factories which largely manufactured relatively low-level airplane parts for export to the US and Canada. The structure of Mexico's industry at that time reflected its roots in the first efforts of US manufacturers such as General Electric to take advantage of market access afforded by the North American Free Trade Agreement in 1994. Even as recently as 2007, the Mexican aerospace sector consisted largely of the subsidiaries of global aerospace firms.

But that picture has changed. By 2012, both the number of Mexico's aerospace production sites and the value of its exports had nearly doubled. Contributing to that trend was a shift toward the production of more technically sophisticated and higher value-added products and services, such as electronic control panels and partially assembled turbine engines for shipment to a wide range of original equipment manufacturers globally. While the subsidiaries of large global players still dominate the sector, Mexican-owned firms—SMEs among them—make up a growing share of the industry.

The Mexican government took a number of constructive steps that contributed to the sector's overall success, such as significant investments in infrastructure, education, and training. The government also carried out policy actions designed to help Mexican firms enter new markets and satisfy international standards. These included trade liberalizing agreements to lower conventional barriers to trade, bilateral air safety

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### **Mexico Boosts Aerospace Exports and the Fortunes of a Small-scale Textile Producer** *(continued)*

agreements with the US Federal Aviation Administration (FAA) on product and production process quality standards established by the aerospace industry, and international agreements for the control of sensitive technologies, such as the Wassenaar Arrangement.

Among the standards that apply to the aerospace sector, the most critical for the Mexican SMEs were the FAA rules on air safety and industry quality standards. The FAA rules effectively govern access to the world's largest and most lucrative aerospace market. Achieving certification under the industry quality standards would prove instrumental to satisfying the FAA's requirements. Equally important, by virtue of the Bilateral Aviation Safety Agreement the Mexican government reached with the FAA, Mexico's own Directorate General of Civil Aviation would be responsible for certifying parts, components, and aviation systems produced by Mexican firms under the arrangement.

In addition to the market access guaranteed by NAFTA, including liberalization of the US Buy American Act rules that govern US government procurement, the agreements on standards have helped make Mexico the seventh largest supplier to the US aerospace industry. Some three-quarters of Mexican aerospace sector exports are destined for the US market.

#### **Path to Internationalization**

Soisa, a Chihuahua-based maker of passenger seat assemblies, seat coverings, and a variety of other systems, parts and components, offers an example of trends driving Mexico's aerospace sector. As recently as 2006, Soisa (then named *Fábrica de Ropa Diamante*) was a nearly bankrupt textile producer fighting for its commercial life in the face of a flood of cheaper Chinese imports.<sup>a</sup> Declining sales of denim jeans the firm manufactured in Chihuahua led its owners to pursue alternatives.<sup>b</sup>

Javier and Jesús Mesta, who had inherited the company from their father, recognized that the skills of its workforce and the company's own past success in textiles could provide an entry into Mexico's growing aerospace sector.<sup>c</sup> Among their first product offerings were seatbelt straps and seat covers.<sup>d</sup> Since then, Soisa increased its technical sophistication and strengthened its position within the aerospace value chain to the point where it now designs and produces entire seat assemblies, including its original seatbelts and coverings.<sup>e</sup>

The biggest obstacle Soisa faced in translating its manufacturing excellence and workforce skills into a winning formula was gaining certification under AS9100, the quality management standards applicable to aerospace companies.<sup>f</sup> Major global leaders in the sector such as Boeing, Airbus, Bombardier, and Embraer, which organize the lengthy supply chains that deliver aircraft to customers, require that all of their suppliers—from producers of major engine systems to minor industrial fasteners—satisfy those standards.<sup>g</sup>

In other words, without AS9100 certification, Soisa had no market, much less an opportunity for internationalization.<sup>h</sup> By the same token, however, achieving certification

would enable it to sell to a truly global market. Therefore, the Mesta brothers decided to close their textile company and use whatever capital they still had to invest in obtaining AS9100 certification. This investment would be significant, not only in terms of out of pocket costs, but also in the time required by managers and production workers.<sup>j</sup> Moreover, the costs are recurring; maintaining AS9100 certification requires ongoing audits and periodic recertification.<sup>j</sup>

Soisa received help in achieving its initial certification by TechBA, the tech start-up business accelerator program created by Mexico's Ministry of Economy and the U.S.-Mexico Foundation for Science, a fund created by legislation implementing NAFTA.<sup>k</sup> As a part of the program, the Mestas received not only advice and guidance that helped them through the certification process, but also assistance in developing their initial market access strategy and management of their operations.<sup>l</sup>

The investment in the standards certification process proved to be worth the effort. As is often the case, the certification process created internal disciplines that served the company well in its efforts to break into a new industry.<sup>m</sup> The company's focus on quality is captured in its mottos "Do it right the first time" and "Always surpass the client's expectations."<sup>n</sup> That focus on quality has allowed Soisa to grow from seven employees in 2007 to nearly 200 today.<sup>o</sup> Its sales have increased 10 times over, and virtually all of its production is exported to the US and other international markets.<sup>p</sup>

a. TechBA, *Soisa, Conquering International Markets* (2014) ("Conquering Markets"), <http://techba.org/2014/en/success-stories/soisa-conquering-international-markets>.

b. *Ibid.*

c. Fundación México-Estados Unidos para la Ciencia, FUMEC: Strengthening the Mexican Aerospace SMEs, FUMEC Newsletter (June, 2011) ("Strengthening Mexican SMEs").

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**products.** These programs would delineate the roles various mandatory and voluntary standards play in opening up trade opportunities, identify the governing and certification bodies involved, and describe methods of compliance, auditing, and so on. Some possible approaches include sector-based guidebooks, online collection of forms, collaborative efforts with trade associations, and seminars and/or training sessions. Related initiatives undertaken by the Inter-American Development Bank include the INTrade Database, a free-access online gateway that brings together information on trade agreements, rules of origin, and other regulatory measures that may affect LAC exports. A second is ConnectAmericas, which standardizes, articulates, and integrates in a single technological platform all the services and information offered to regional SMEs to promote their internationalization.

- **Support development of management systems in firms that allow for checks and balances during production for meeting standards.** Rather than focusing on end-point compliance only, such management systems would create appropriate policy guidance for compliance management systems. These efforts can be coupled with case studies of LAC SMEs in key sectors that use standards effectively for trade and competitiveness.
- **Train SMEs to meet rules of origin in RTAs and to navigate the RTA spaghetti bowl more strategically.** Workshops would teach SMEs to fill certificates of origin required in a given RTA. Customized training would be provided to SMEs to learn what, if anything, they must do to meet the rule of origin in their product category in light of their pre-existing supplier relationships. Such training should then go on to help SMEs develop a strategy to navigate the various preferential channels, for example, in selecting to export to RTA markets with rules that are easiest to meet.
- **Integrate the unique needs and priorities of LAC SMEs into broader efforts to raise domestic standards development and dissemination, and to facilitate compliance with both private and public standards.** Such integration might focus on the costs and availability of reliable services and skilled people for metrology, laboratory testing, calibration, and auditing.
- **For broader-based gains, seek to converge the manifold cross-cutting RTAs into broader integration areas with a single set of rules of origin, standards, and other norms.** Countries on Latin

America's Pacific rim have made important progress in this area, and gains for SMEs will likely follow. Two important issues must be kept in mind in driving these efforts. One is that rules should be converged toward the most flexible model; tightening rules of origin would defeat the purpose of convergence and could even breach multilateral trade rules. Second, the silver bullet for reducing the negative impact of rules of origin on trade is the economist's panacea: multilateral trade liberalization. With MFN tariffs at zero, preferences and rules of origin lose their meaning.

#### IV. Information Barriers

We conclude this chapter with a brief discussion of the impact of information barriers on SME internationalization. These are hardly trivial: SMEs tend to lack adequate information about global markets and customers. They also face higher costs than do large firms for assembling and utilizing the right information. This compounds the effects of the external costs and constraints discussed earlier in this chapter, which are as follows:<sup>60</sup>

- Sunk entry costs as well as the fixed costs, per-unit profits, and projected levels of risk that are part of the ROI assessment.
- Border administration and transportation issues that determine trade costs.
- Knowledge to leverage preferential treatment under RTAs and to meet rapidly evolving product and social responsibility standards.
- The ability to evaluate, prioritize, and upgrade the range of internal assets and capabilities necessary for initial export activity and ongoing export success.

Lack of information has been prioritized as a top export barrier in several survey- and interview-based studies conducted in the US, Europe, and newly industrialized Asia.<sup>61</sup> It is both a frequent and serious obstacle. In planning and managing export growth, firms must gather and synthesize information about many different market characteristics: market structure, consumer preferences, channel alternatives, business practices, and specific opportunities, among others. Firms must also assemble a mix of information about the competitive situation of their sector and the products

essential for adopting the right export business model and for reshaping the ways in which their design, production, and marketing may need to differ dramatically from prevailing domestic practices.<sup>62</sup> The need for many kinds of operational and logistics information further adds to the length of the list. Compared to business as usual in the domestic environment, exporting is an information-intensive activity.

Information barriers are a two-way street. On the one hand, exporters may lack core information on market demand, partner reliability, buyer needs, product standards, and more. On the other hand, buyers may lack information on the exporter's reputation, and thus the quality and characteristics of its products. The discussion that follows outlines both sides to this obstacle. We conclude with a note about the role of export promotion activities in overcoming the underlying market failures.

### **A. Information on Markets, Customers, and Partners**

#### **1. General themes**

The process of gathering and assessing the reliability of the range of data required for exporting is costly. Consider the issue of vetting the trustworthiness, timeliness, and capabilities of trade partners. In general, as the geographic, cultural, and/or linguistic distance between firm and market grows, so too do the difficulties faced in accessing pertinent, high-quality information. Information barriers are aggravated under two other conditions as well: when a partnership decision is harder to reverse, and when the domestic business community is uncertainty-averse, i.e., more sensitive to informational ambiguity and less likely to veer away from familiar partners. While there has been no direct quantification of the relative importance of information barriers, survey data indicate that the obstacle is both common and critical. For example, in a survey on exporting by 460 British firms, identifying the initial buyer contact was among the most common bottlenecks. Surveyed firms also reported difficulties in creating and building the dialog with customers and trade partners.<sup>63</sup>

#### **2. Are SMEs hit the hardest?**

Management theory and common sense would lead us to assume that information needs should be especially problematic for SMEs because of their liability of small size. Unlike large firms, they lack the substantial internal resources and external relationships needed to acquire, organize,

and continually update comparative information on markets, logistics, and buyers. Moreover, the information acquisition that precedes and then underpins successful export entry often requires face-to-face contact to deepen feedback and provide greater accuracy. In fact, acquiring specific knowledge about markets, production technologies, product quality, and delivery standards typically requires either experienced international managers or other forms of international exposure and training, or collaborative, long-term trade and business linkages with customers, vendors and channels.<sup>64</sup> Here again, due to limited financial and human capital resources, SMEs are generally at a disadvantage.

Yet concrete research on the relationship between information and SME export performance has been limited. This stems in part from the difficulty in assessing the quality of information derived, differentiating among different types of intelligence, and measuring a firm's capability to translate information into knowledge and action. It may also be that information and exporting producing benefits only once a "hurdle rate" is reached, i.e., the point at which senior management is comfortable moving forward and/or expanding the internationalization effort.<sup>65</sup> The theoretical focus of other papers restricts the applicability of their findings beyond their specific datasets. Finally, the literature provides few examples of SMEs from developing countries, and particularly from LAC.

At a general level, however, both theoretical and empirical research findings agree on a central point: SMEs' limited ability to acquire information about foreign markets is a major reason for their relatively low levels of exporting commitment and poor performance.<sup>66</sup> Meanwhile, successful SME exporters (where success is defined by a relatively larger percentage of foreign sales) tend to give greater importance to the search for specific information and the use of a much broader range of information sources than their less successful counterparts.<sup>67</sup>

### **B. Reputation and Image**

When exporters enter or expand in a market, customers look either to brand name or to the firm's reputation as a proxy for product quality. The issue of reputation is especially important in the purchase of differentiated goods, for which pricing cannot fully signal the relevance and quality of a product's bundle of attributes. Reputation is also crucial in the case of sophisticated and/or custom-experience goods, for which quality can be deduced only upon consumption after purchase.

When a firm is not well known, buyers substitute their perception of the country of origin as a proxy for firm reputation. In many cases, SMEs from developing economies start out behind the eight-ball, since products from developing countries are often perceived as technologically less advanced and of poorer quality than those of companies from developed countries. Inherent in this dilemma is an additional asymmetry: low-quality producers can generate negative informational externalities that affect the profits and share of high-quality producers from the same country.

The following box on the Brazilian publishing industry describes an initiative to improve brand at the country-sector level. (In Chapter 6, we present another integrated approach to image building and exporting.)

### **C. Immigrant Networks, Intermediaries, and Information Barriers**

The importance of information for trade has been indirectly surmised from observations of immigrant business networks, such as the Chinese Diaspora. These communities help match exporting firms with trade partners, reducing information search times and costs. The effect of the Chinese network has been found to be larger for differentiated goods than homogeneous goods, which may also illustrate the network's role in confirming product quality for potential buyers.

An analysis of re-exports of Chinese differentiated goods by Hong Kong intermediaries shows a markup of between 9 and 13 percent. This markup can be interpreted as the value of the information cost reducing services provided by these intermediaries.<sup>68</sup>

Research conducted by matching historically determined emigration stocks with detailed firm-level data from Portugal bears out a similar set of conclusions.<sup>69</sup> The authors hypothesize that the fixed costs associated with gathering information about demand and distribution should be lower in destination markets with a greater number of potential contacts, leading to a greater probability of market entry and larger export revenues. Their results show that large numbers of emigrants in a given destination increase export participation and export intensity. Further, export participation tends to be largest among firms that are more likely to have close ties with the emigrants.

### **D. Policy Issues**

Asymmetries in information and related high costs in accessing necessary information are a key market failure affecting SMEs' export performance. Export promotion activities commonly seek to correct some of the more



### **Brazil Aims to Increase the Global Awareness and Prestige of Its Publishing Sector**

Before the early 1990s, Brazil had been a relative outsider within the book publishing community. Then the country gained a reputation as a producer of niche and “exotic” books. Now Brazil is investing significantly to broaden its image in export book destinations yet again, aiming to develop a reputation that has more contemporary and international appeal.

Through the Ministry of Culture, the Brazilian government has committed \$35 million to support the country’s publishing sector by 2020 through scholarships for translation, exchange programs, and participation at international book fairs. Already, 311 translating scholarships were granted between 2011 and 2013 (more than double the number between 1900 and 2011), and the government recruited 92 Brazilian authors to act as literary ambassadors in 2013. A major campaign was launched in October 2013 at the Frankfurt Book Fair, where Brazil was featured as the guest of honor. The 500-year-old Frankfurt Book Fair is the world’s largest event of its kind, attracting a global audience of more than 300,000 publishing industry professionals, including many involved in the purchase of foreign reprint rights. It also hosts more than 7,300 exhibitors from 100 countries each year.

Activity at the fair by the Brazilian government was extensive. The 2,500-square-meter 2013 Brazilian pavilion was nearly nine times the size of the previous year’s guest of honor, New Zealand. The government further invested some \$8 million in cultural programs at the fair to highlight the presence of Brazilian publishers and their offerings, which included Brazilian theater, dance, music, and video. More than 20 Brazilian authors read from their work on stage, while the Brazilian pavilion hosted 70 authors and 164 publishers. Participating firms represented one-third of all Brazilian publishers. As a percentage of literary houses, this number is likely much higher, because many publishers specialize in educational titles, the trades, and nonfiction categories. Note that Brazil has only about a dozen large publishing companies; therefore, virtually all of the 164 publishers at Frankfurt were SMEs.

A sketch of Brazil’s publishing industry provides a context for these public sector efforts. In 2011, global publishing giant Penguin purchased 45 percent of Companhia das Letras, a large fiction house and a recognized trailblazer in marketing and public relations. The Penguin-Companhia marriage is likely to make an important contribution towards boosting the sector’s reputation overseas, as Penguin introduces new Brazilian literature to English-speaking audiences. At the same time, this development and several other consolidations among already dominant publishers on the domestic front has increased the pressure for SMEs to identify and pursue new growth strategies.

For Brazilian SME book publishers, exporting is one of the main growth alternatives. In fact, exports are doubly important because the domestic market promises little growth in the short run. First, while it is true that Brazil is among the top ten largest

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### **Brazil Aims to Increase the Global Awareness and Prestige of Its Publishing Sector** *(continued)*

publishing markets worldwide, much of this can be attributed to government purchases for public education and other sales. Second, well-known foreign authors comprise a very large percentage of Brazilian bestsellers, but these authors are ordinarily represented by the very largest firms (Companhia in particular). Third, Brazil's relatively high illiteracy rates yield reading rates quite a bit lower than in other countries. For example, Brazilians averaged 1.3 books per year in 2011, versus 6 to 16 books per year in the US, depending, on the research source. Individual Brazilians spent 5 hours 12 minutes reading per week versus 10 hours 42 minutes per week in India.

As of late 2013, Brazilian literature appears to have found a widening audience in Germany, Italy, and France. Brazilian books also sell in such LAC countries as Argentina, Mexico, and Colombia. While it is too early to gauge its long-term impact, the global awareness program provides insight into the many facets involved on reputation building at the country-sector level in order to reduce information barriers to export success. The case also points to the spillovers from a strong and positive perception of large companies and their product offerings in shaping the image for SMEs in foreign destinations.

*Sources:* Frey, Louisa, "Literature is Brazil's New Export", Cultural Exchange Brazil – the Netherlands, August 10, 2013; Campassi, Roberta, "Penguin Buys 45% of Brazil's Companhia das Letras", Publishers Magazine, Dec 6, 2011; Mello, Juliana "The Brazilian Publishing Market" 2012; World Culture Score Index 2013

prevalent information problems facing internationalizing companies. Trade assistance can go a long way towards reducing the costs and complexity of information gathering, whether in up-front or ongoing studies on markets, pricing, competition, buyers, and partners; or in relation to trade costs and trade compliance; or for assessing and upgrading internal capabilities and organizational processes. Trade assistance addresses the potential for third parties to "free-ride" on the information search activities of market-leading exporters, which would otherwise discourage companies from gathering the requisite information to take action in export markets. Such assistance is especially important in helping firms open up new export initiatives by market or product offering, because this is where the lack of information is likely to be more acute.<sup>70</sup> Additionally, assistance often addresses market failures related to training and the ability of SMEs to internalize and use information to their advantage in their exporting initiatives.

Volpe (2010) substantiates that these initiatives can reduce information barriers for SMEs in particular.<sup>71</sup> In that study's analysis of the impact of Chile's PROCHILE and Argentina's EXPORTAR over the period 2002–2006,

that study showed that programs resulted in significant impacts on firms' intensive and extensive margins, with SMEs benefiting more than larger firms.

In Chile, numbers of firms served by PROCHILE increased from 5 percent to almost 30 percent of the country's exporters. Of these, more than 60 percent of those receiving assistance in any given year were SMEs. The rate of growth of exports for firms assisted by PROCHILE averaged 7 percentage points higher than for firms that did not receive assistance. While the total number of destination countries for the country's overall pool of exporters grew just slightly during this period, PROCHILE clients experienced a rate of growth that was 2.5 percent higher than their counterparts in terms of number of destination countries. The rate of growth of average exports per country and the average exports per product were 4.4 percent and 6.5 percent higher for supported companies, respectively. Results of group-specific estimations indicate that the effects were greatest for smaller, relatively inexperienced firms. As the author observes, these are the firms that face the greatest challenges in overcoming informational barriers.

In Argentina, EXPORTAR's clients were over 80 percent SMEs; EXPORTAR programs were linked to an increased rate of growth of firms' total exports (14.1 percent higher for assisted firms), the number of countries to which the firms exported (10.4 percent higher), and the number of products exported (9.7 percent higher). The effects on the extensive margin were even higher for firms being helped by EXPORTAR for the first time: 19.4 percent higher in terms of the number of destination countries, and 13.1 percent higher for the number of products exported. With respect to firm size, the program's impact on rate of growth in overall exports was strong for small firms, and strongest of all among medium-sized firms.

Slightly different results are implied by preliminary evidence based on data on APEX-Brazil. In this study, APEX-Brazil appears to enhance the likelihood that a non-exporter firm becomes an exporter, especially among micro, small and medium-sized firms, but not among large firms.<sup>72</sup>

This general contrast between SMEs and large firms is also found in preliminary evidence from outside the region. Research using four different Belgian datasets indicates that SMEs benefit significantly (whereas large firms do not) with regard to the rate of growth of total exports. This study also points to a time lag of one to two years between assistance and results, suggesting that patience is warranted in evaluating the performance of specific institutional actions.<sup>73</sup>

In addition to direct trade assistance, there are other ways to reduce information asymmetries facing internationalizing SMEs. These range from Internet-driven strategies to guaranteeing buyers against defective products in order to enhance reputation, to promoting industry consortia so that firms can share in information gathering and training. We look at specific support innovations in Chapter 6 and discuss the Internet and SME exporting in Chapter 9.

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# Intra-Firm Determinants of Export Success

## 4

### I. Introduction

Internationalization involves a very high degree of organizational complexity, significant management commitment, and an ongoing investment of capital, knowledge, and other resources. Such requirements intimidate, impede, or disqualify many SMEs from pursuing growth through exporting. What investments must a successful LAC SME exporter make? What are their key characteristics and objectives, and how can these be enhanced? How can a firm best design, achieve, and sustain a stable stream of profits from overseas markets through its management and organization? This chapter contributes to a growing field of inquiry that explores how intra-firm activities and the decisions of the individual firm affect export performance.

Ultimately, successful internationalization depends on firm-level factors. It is clear that some firms are able to exploit country- and industry-specific advantages in the international markets far better than others of equal size, sector, and age. Recall the lesson of the Melitz model of firm heterogeneity presented earlier in this report: only the subset of more productive firms self-select into export markets. This is because their higher efficiency enables them to overcome the entry costs of trade. In more technical terms, these firms exhibit a superior total factor productivity (TFP), i.e., a firm's efficiency in putting a given set of capital and labor inputs to use. There is quite a bit of debate among economists and management scholars as to exactly what drives TFP. Despite the many gaps in our knowledge, much has been clarified on the relation of TFP to export trajectory. The fact that productivity is a determining catalyst for entry into and exit from exporting underscores why intra-firm analysis is so essential when considering SME internationalization.

The following material draws on several sources. One is the ocean of work spanning decades that includes many papers that address granular determinants of export performance on an array of issues, such as management characteristics, marketing systems, production methods, technology accumulation, and more. These studies typically test a few variables in isolation. Our methodology synthesizes from among select research in this group, extracting key themes and valuable insights. Further, we have

filtered and aligned this work with leading business management scholarship in disciplines such as strategic development, marketing strategy, operational strategy, organizational strategy, and small business operations. We believe that cross-fertilizing the economic and trade literature with accepted management theory provides a level of coherence with how SMEs typically operate.

It should be noted that this material takes into account major messages from prior chapters in the report, namely, that LAC SMEs exhibit very high rates of export churn, low export participation, diversification, and intensity. At the same time, it is important to note the dearth of research specific to the dynamics of regional SMEs. Hence, we seek to target and place in context those findings likely of greatest importance to emerging market SME exporters, and (where possible) LAC SMEs.

This chapter focuses on direct exporting only, which is by the far the most familiar. While a comprehensive verdict regarding the determinants of intra-firm export success drivers and their prioritization is not yet possible, we hope to spur new thought on key issues, their overall mix, and the implications for support and policy guidance.

The chapter is organized as follows: Part II presents our analytical framework, discusses each of eight export success drivers. Part III reviews lessons that might be learned from the born-global exporter. Part IV concludes the discussion and presents policy implications.

## **II. Examination of Export Success Drivers**

### ***A. Framing the Analysis***

Both managers and researchers have long observed that exporting is a world of enormous detail. To export successfully, the firm must define its competitive international strategy and positioning; target the best-fit markets and customers; select and negotiate with qualified agents and/or distributors; manage that distribution channel; calculate and set international pricing; complete shipping and customs documentation; promote product offerings; establish service accounts; learn the needs and requirements of its new customers; and more. It must do all this while effectively allocating capital, monitoring performance, and minimizing risk.<sup>1</sup>

Because of the many activities involved in exporting, determining what takes place inside the firm to distinguish the successful SME exporter from its peers can be tricky. Based on an extensive list of econometric studies, case research and firm profiles, and synthesizing both economic and business

	<b>Export Success Driver</b>	<b>Required Characteristics (some examples)</b>
<b>Assets</b>	Management	<ul style="list-style-type: none"> <li>International background and vision, external orientation</li> </ul>
	Capital	<ul style="list-style-type: none"> <li>Working capital and growth capital available for exporting</li> </ul>
	Workforce	<ul style="list-style-type: none"> <li>High skills intensity, sectoral-specific skills in many niches</li> </ul>
<b>Capabilities</b>	Planning	<ul style="list-style-type: none"> <li>Systematic methodology, historical process accounts for risk</li> </ul>
	Product strategy & adaptation	<ul style="list-style-type: none"> <li>Optimizes match with export market, invests in product winners</li> </ul>
	Relationship development	<ul style="list-style-type: none"> <li>High trust, communications, contact with foreign buyers/channels</li> </ul>
	Production & delivery	<ul style="list-style-type: none"> <li>Always meets foreign requirements on price, quality, schedule</li> </ul>
	Technology & innovation	<ul style="list-style-type: none"> <li>Adapts, particularizes, improves upon codifiable knowledge</li> </ul>

research, we have teased apart eight key elements that determine successful internationalization by SMEs. They are

On the surface, these success drivers may appear similar to the factors that drive sustained performance in the domestic environment. And as a group of categories, they may well be largely the same. It is in the specific attributes, characteristics, and objectives of each success driver that they differ. For example, management caliber clearly matters to performance, regardless of market. However among SME exporters, it is management’s prior international experience and general international vision that greatly influence the odds for success.

In structuring our analysis we have borrowed (in a simplified format) an analytical framework from the field of business strategy development and management. This resource-based or capabilities framework is one of a few leading sets of theories that seeks to identify the means by which a business achieves and maintains a superior competitive position. This approach locates the source of a defensible position (e.g., a position that will continue to generate superior profits over time) in the distinctive resources the firm has developed, which are in turn made up of integrated combinations of both assets and capabilities.<sup>2</sup>

In this view, assets are the resource endowments that a firm has accumulated—brand equity, efficient production, government support, and so forth. Deeply embedded within the organization’s DNA are its capabilities,

those bundles of skills and accumulated knowledge, applied through organizational structures and cutting across functional boundaries. Capabilities are the glue that brings assets together and enables them to be coordinated and deployed advantageously; they can be especially hard to build.<sup>3</sup> Further, capabilities give rise to business activities (which for SMEs typically take place inside the boundaries of the firm, but not always) and are manifested in the particular ways in which these business activities are carried out.

To make this concrete, consider Walmart's logistics system—a core business capability.<sup>4</sup> This system uses and coordinates several assets: specialized software to track store-movement data; company-owned warehouses configured for rapid sorting, repacking, and dispatch; and management with heavy expertise in and commitment to efficient inventory management. This capability also gives rise to multiple business processes at any given time, from keen supplier oversight to streamlined transportation routing. Each of these assets and/or activities would not generate the significant and hard-won value that the overarching capability provides.

In much the same way, this framework is helpful in conceptually organizing the SME export success drivers detailed in this chapter. Take as an example the particulars of the planning capability essential to SME export success. As the forthcoming discussion will show, this capability must be systematic and entrepreneurial to have the ability to adjust for risk and account for growth. Thus, the planning capability leverages and coordinates key assets: management with relevant knowledge, a workforce that can carry out the planning imperatives, and capital available to fund research and monitoring processes. These assets in and of themselves cannot further the export agenda except through their manifestation in specific capabilities.

This emphasis on capabilities as complex bundles of skills and knowledge also appears to be in line with what seems to be an emerging observation in the literature on exporting. That viewpoint holds that in order to sustain internationalization, many emerging market SMEs must transform management mindsets that have enabled them to serve the domestic market and embark on the wholesale restructuring of their business models and/or practices to fit the needs and rigors of internationalization.<sup>5</sup>

The research we present strongly suggests that the more an SME has fully developed each of these success drivers, and the better prepared it is to invest to make further improvements, the greater its chances for success. Taken as a whole, these assets and capabilities also provide a lens for evaluating and mitigating major obstacles likely to impede an individual firm's export path.

Following are three further methodological issues:

- The eight success drivers are applicable across industries, including SMEs in both goods and services. However, additional research is required to pinpoint priorities by sector.
- The success drivers are interrelated. It is no coincidence that among international business executives, exporting is likened to the launch of a new venture. Every function and area of decision making within the firm is brought to bear on ensuring the export's success. In our analysis we look at each determinant in isolation; further research would isolate correlations and secondary impacts.
- It is difficult to differentiate among those drivers that enable export entry, versus survival, versus expansion. Where the data on this are clear, we present it. Otherwise, it appears that a firm must continually deploy and refine a core set of assets and capabilities at various stages in its export journey.

The remainder of this section details each export success driver.

## **B. Firm Assets**

### ***Success Driver #1: Management***

Both SME export entry and SME export success are decisively shaped by the characteristics of senior management, particularly the owner. As evident throughout this report, exporting brings with it high levels of risk, expense, and uncertainty for SMEs. It follows that both the decision to export as well as the ability to stay the course in the face of problems require a high degree of comfort and savvy from the firm's leadership team in navigating foreign waters.

A long list of studies from many world regions proves this principle. As one group of researchers states: "Management is the major force behind the beginning of development, sustenance and prosperity in exporting."<sup>6</sup> Others note: "Management characteristics play a significant role in influencing export sales unit effectiveness."<sup>7</sup>

This literature has isolated a handful of critical management attitudes and skills. They are:

- *International orientation and background*: International orientation and international vision are reliable forecasters of export performance.

They enable the SME owner or lead executive to see overseas opportunities and deal with export threats.<sup>8</sup> Most often, positive international attitudes derive from managers' prior experience doing business in or with foreign markets, resulting in a valuable mix of skills and relationships. Studies have confirmed the link between prior management export experience, as well as foreign language proficiency, with export propensity and export intensity.<sup>9</sup> It is relevant to note that foreign equity (partial ownership) in SMEs was a major determinant in the export successes of the Asian newly industrialized countries during the 1970s and 1980; foreign equity continues to be more dominant among those Asian SMEs that exported aggressively from the start.

A recent study found that management's international background must be specifically related to a firm's export markets. When this is the case, the effect of management's market-specific experience is at least as strong as that of firm productivity. This rigorous analysis combined multiyear Portuguese labor and trade data (across all sizes of firms) to explore whether management's export experience mattered when managers move across firms. The results: having managers with experience in a specific market increased the probability by at least 22 percent that the current firm entered a market by with respect to the entry probability of an average firm in the sample. While the impact was significant but slight for staying in the market two years in a row (0.7 percent), both effects were on par or greater than that of firm productivity. Further, when firms stayed in the market, management's market-specific experience increased the value of exports by 20–69 percent. Meanwhile, the researchers found no evidence of a significant relationship between export experience that was not specific to a firm's destination market and its trade performance.<sup>10</sup>

- *Export commitment:* SMEs that pursue export markets backed by ongoing management support are far more likely to achieve greater export performance. Management commitment critically influences export success, probably by allowing for careful planning, successful export marketing strategies, and a sufficient allocation of resources.<sup>11</sup>

Leading the export initiative successfully requires that SME management embrace the opportunity for exports to contribute to profits while understanding how to manage expected risk, costs, and complexity.<sup>12</sup> Survey data in the US and Europe alike illustrate that SMEs



that have not yet begun exporting find barriers to be more onerous than do firms that are already exporting (depending on the question, anywhere from 11 percent to 29 percent higher in Europe).<sup>13</sup> These findings help to explain why capacity-building programs can play a role in SME export success. Well-structured training not only transmits specific content but also operates at a meta-level, alerting management to potential problems and solutions.

- *External orientation:* A “market-in” view of how to manage—that is, an approach that prioritizes both the customer and the competition—generally distinguishes successful SME exporters from those that

### **The Importance of Management’s International Orientation: Pioneering Exporters from Argentina**

An Inter-American Development Bank research initiative in Argentina illustrates with great specificity the importance of management’s international savvy. The study constructed cases from the experiences of pioneering exporters from four SME-dominated sectors with semi-differentiated products: light ships, television programs, wine, and wooden furniture.

The researchers studying these firms were struck by the degree of uncertainty facing each of them in assessing the potential of the export venture, and the multiple levels on which this uncertainty operated. Included was uncertainty in selecting new equipment for production upgrades, in targeting the right markets, and the overarching uncertainty of determining which marketing and product dimensions were most critical to their particular circumstance.

In every case, the pioneering firm’s management possessed an unequivocally superior understanding of foreign countries’ cultures, tastes, and ways of doing business. This knowledge was acquired prior to the decision to export, through socialization with foreigners and in foreign markets. In one case, the firm had been importers first, taking regular trips abroad and having frequent contact with foreign agents. In another, the key manager had studied and worked for several years in the US. Yet another manager had lived briefly in the US as a teen, an experience which led to continued social contacts with Americans in Argentina.

International orientation and background functioned strategically by enabling management to overcome the uncertainty hurdles in the export journey in ways that other domestic entrepreneurs in the same sectors were not equipped to manage.

*Adapted from “Challenges of Exporting Differentiated Products to Developed Countries: The Case of SME-Dominated Sectors in a Semi-Industrialized Country,” Artopoulos, Friel and Hallak, 2010.*

struggle. In particular, greater management confidence in the competitiveness of their export product has been found to increase a firm's export intensity, while a higher level of customer orientation contributes to effective performance.<sup>14</sup>

### ***Success Driver #2: Capital***

SMEs must have capital in order to overcome the sunk costs inherent in internationalization. Capital is also needed to pay the ongoing expenses to manage the export program, including the development and maintenance of the firm's vital export capabilities. Even ad hoc export activities, responding strictly to inbound requests, require an additional outlay of funds over and above the SME's historic focus to manage transportation, logistics, customs, documentation, insurances, customer contact, and so on.

The majority of LAC SMEs are not likely to have access to sufficient cash reserve and free cash flow from their core (domestic) business to fund the export program. Moreover, they may not be willing to commit resources to a relatively risky endeavor. The option is access to some form of external financing. Research shows that companies with better access to credit are more likely to export and more likely to be more intensive exporters, whether the firm is large or small.<sup>15</sup>

Against this backdrop, it is critical to highlight that financing mechanisms for SMEs are often limited, whether for export related working capital or growth needs. The capital constraint to internationalization is so significant for regional SMEs that this report devotes two parts to its discussion. A detailed description of current access to finance in the region is provided in Chapter 5, while Chapter 6 describes several innovations for alternative financing solutions and emerging financial vehicles.

### ***Success Driver #3: Workforce***

The region's lag in education and skills presents a general and significant challenge to LAC SMEs. Nearly 37 percent of LAC companies identify the difficulties in finding workers with the necessary training as one of their main obstacles, which is higher than both the global average and the average for other developing regions.<sup>16</sup>

It is likely that the gap between education and skill requirements also constrains SME export growth. First, the gap impedes the enhanced productivity that makes it possible to fund sunk costs. Second, it handicaps companies in building the critical and often fairly sophisticated capabilities essential for successful internationalization.

In an interesting nuance, a study using empirical evidence from a panel of Argentine manufacturing firms for the period 1998–2000 indicates that firms exporting specifically to high-income destinations outside the region hire (and thus require) more skilled workers. The authors further state that the domestic markets in Argentina are similar to middle-income export markets, making it possible to observe differences in outcomes only with regard to exporting to high-income countries. This work posits a theoretical framework in which exporters to high-income destinations hire more skilled workers in order to engage in quality upgrades, and because skill-intensive services are needed to export to high-income countries.<sup>17</sup>

Case studies further suggest that SMEs that employ a skilled workforce tend to export more. For example, analysis of data from 55 Indian SMEs exporting via the Internet provides evidence that general skill intensity of the workforce (computed as the ratio of workers with professional degrees to the total workforce) is a determinant of export success. In the view of these researchers, Indian SMEs can survive in the Indian market by employing less skilled workers that are paid lower wages, while export-oriented firms need skilled workers for advanced/specialized marketing, business development, product design, and on-time delivery activities.<sup>18</sup> This logic would seem to hold for other developing countries as well.

Apart from generic skills such as literacy, numeracy, and general skill intensity, it appears likely that a dearth of labor with requisite sector-specific skill sets can constrain firms in many industries from exporting at the scale and scope otherwise possible. Such sectors may include advanced manufacturing, media- and design-driven business, digital businesses, and a variety of services. Growth in many specialized sectors is likely to be of overall importance to national and regional economies. As such, this is an area that warrants additional examination, particularly for the LAC region.

### **C. Firm Capabilities**

#### ***Success Driver #1: Planning***

Since the initial adoption of planning processes by business in the 1930s, the field of management science has proven without question that when businesses do not employ a systematic planning process they face an overwhelming constraint to consistent growth and performance. Planning is the capability to prepare for action, by transforming information into insight and next steps. It is the means by which businesses manage complexity—and exporting is nothing if not complex.

### **ArtInSoft of Costa Rica: Technology Leadership as Key to Growth**

Over the past two decades, Costa Rica's technology sector has grown into one of Latin America's most dynamic industries. The main focus of the sector's more than 300 companies is developing software for local and international markets. Costa Rican industry also plays an important role in manufacturing. As a consequence, the country's software exports exceed those of any other country in Latin America and the Caribbean on a per capita basis. Moreover, largely due to Intel's investment in integrated circuit production in 1998, computer components have supplanted bananas as the nation's main export product.

The sector's success is owed to the strength of its entrepreneurs together with Costa Rica's investments in education and its efforts to attract technology investment from global leaders. While many studies date the growth of Costa Rica's tech sector from Intel's investment, the story begins much earlier.

Costa Rica made significant investments in technology education in the 1970s and 1980s, with the help of IDB funding. Those efforts began with the 1974 expansion of the Costa Rican Technological Institute (ITCR), which led to the development of one of Latin America's most advanced computer science and software engineering departments. Additional investments in the Informatica Educativa initiative in the early 1980s created computer literacy programs that benefited a broad segment of the Costa Rican workforce. More recently, the growing tech sector received support from a Science and Technology Program that funded 239 postgraduate scholarships, 90 research and development projects, and a variety of laboratory and computer equipment at 16 research facilities across the country.

In many respects, the local industry grew out of those investments in education and training, particularly ITCR's strong focus on applied research and cooperation with industry. Much of the institute's research is funded by the private sector, which fosters close cooperation with industry on practical solutions to real world technical and commercial challenges.

The institute's focus on these real world challenges proved instrumental in Costa Rica's effort to attract Intel as an investor, which became the linchpin for the entry of other major global tech companies to Costa Rica. In coordination with Intel engineers and production workers, the institute designed a special two-year training program to prepare workers for the proposed Intel plant. The result was a program that produced a trained workforce with skills needed not only by Intel, but by other leading tech companies, including Oracle and Microsoft, both of which have played a prominent role in the expansion of Costa Rica's software industry.

#### **Path to Internationalization**

Early participants in the institute's programs have gone on to teach in Costa Rican technical institutions and to launch successful technology companies of their own. One is Carlos Araya, founder and former chief executive officer of ArtInSoft. Araya graduated from ITCR in 1978 with one of the first degrees offered by its nascent Computer Science Department.<sup>a</sup>

After receiving a doctoral degree in artificial intelligence at the University of Kansas on a Fulbright Scholarship, Araya returned to Costa Rica to teach at his alma mater. He has twice won Costa Rica's national prize for technology innovation.

Araya also started ArtInSoft in 1993 with three other ITCR graduates. Today, ArtInSoft is a world leader in software design and engineering, specializing in three areas: reengineering, which involves adapting older software applications to run on later versions of computers; industrial automation software to help manufacturers improve their productivity; and Internet applications.<sup>b</sup>

As with many tech companies, ArtInSoft began small. Using seed money from Oracle, the company's four engineers set up operations in a small chalet in the hills of Cartago in the middle of a coffee plantation.<sup>c</sup> There, they began developing an Enterprise Resource Planning and Scheduling business software product that would support larger Costa Rican businesses.<sup>d</sup> ArtInSoft's initial success was due to its close proximity to its clients, lower costs than other providers, accessibility, and perhaps most importantly, its ability to speak its customers' language—Spanish. The success of its initial product provided ArtInSoft with both the experience and the capital needed to develop its first foray into migration software. That effort resulted in what became the firm's signature product, called Freedom.<sup>e</sup>

Four years after launching Freedom, ArtInSoft's sales reached \$2 million. While the company did export, principally to other markets in the region, 80 percent of its customers were Costa Rican. At that point, Oracle drew ArtInSoft's team into a major software migration project for one of Oracle's major European customers.<sup>f</sup> ArtInSoft delivered the project successfully—on time and at a considerably lower cost than Oracle's customers might otherwise have paid for the reengineering. With the success of the project, Oracle integrated ArtInSoft into the suite of trusted companies in its supply chain, providing ArtInSoft with the opportunity to collaborate on other projects for major global customers.

ArtInSoft's success in integrating itself into Oracle's supply chain had considerably broadened its exposure and gave it a growing global reputation in the field of software reengineering.<sup>g</sup> The INTEL fund operates as a venture capitalist, investing in companies that support Intel's initiatives in voice and data communications, wireless communications, and mobile computing. The purpose of INTEL's investment in ArtInSoft was to enable telecommunications software applications to run on Intel platforms, specifically Intel's Internet Exchange Architecture.<sup>h</sup> Intel needed software and migration tools for Internet architecture in Latin America and the Caribbean that would aid its own efforts in the region's growing tech markets.<sup>i</sup>

With the fund's investment and its deepening relationship with Intel, ArtInSoft often found itself in discussions with another of Intel's major suppliers, including Microsoft, the largest software company in the world by sales volume.<sup>j</sup> The cooperation between the two software companies resulted in a strategic agreement, which would involve ArtInSoft in Microsoft's own efforts to migrate its software to mobile applications. Specifically, ArtInSoft

*(continued on next page)*

### ArtInSoft of Costa Rica: Technology Leadership as Key to Growth *(continued)*

developed a tool for migrating computer applications in Microsoft's Visual Basic 6.0 to the .NET platform that would allow developers to build web-enabled applications on the Microsoft platform.<sup>k</sup>

ArtInSoft's success in those projects led to its certification by Microsoft as its preferred supplier of software migration solutions for customers.<sup>l</sup> That position, combined with an established reputation for innovation, allowed ArtInSoft to continue to grow even after Microsoft ceased supporting Visual Basic.<sup>m</sup>

By that point, Microsoft had integrated ArtInSoft into the next generation of its software innovations. Meanwhile, ArtInSoft had used its relationship with Microsoft and others to expand its suite of products and consulting services into direct relationships with the information technology departments of major nontech as well as tech sector companies, both within the region and beyond.<sup>n</sup>

As the result of ArtInSoft's success in developing specific software tools that met highly individualized customer needs, and its subsequent integration into the supply chains of among the world's largest tech firms, the company established its own niche in the global computing and software value chain, serving business customers in world markets. Today, ArtInSoft is the world leader in software migration, operating in the tech corridors of the East and West Coasts of the US, consulting with firms, and continuing to develop software. Its customers include many major companies in Latin America, such as Banamex, as well as the largest players in the global technology space noted above.<sup>o</sup>

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n. See, e.g., *ArtInSoft, Banamex - Citigroup turns to ArtInSoft to ensure compliance and business continuity through massive migration to C#.NET*, <http://www.artinsoft.com/banamex-citigroup-vb-to-net-migration-case-study.aspx>.

o. *Ibid.*

While planning is essential for export entry, today's hyper-competitive and dynamic global markets dictate that it must be also be a regular activity in order to achieve long-term survival. A meta-analysis of 33 studies reports recurring evidence that, for all sizes of firm, a defined strategy for exporting activities is a good predictor of export sales. This same aggregate analysis also found that deliberate efforts in planning for exporting appear to lead to improvements in exports sales, operations, and profits.<sup>19</sup> Detailed interviews of 150 highly successful Australian small-scale wine exporters reveal that these firms took particularly great care to plan expansion to each new market, which they did only after they had digested growth in prior export markets.<sup>20</sup>

At a more granular level, Greek SME exporters that used a systematic methodology for selecting foreign target markets performed significantly better in their export markets than exporters who did not.<sup>21</sup> The ability to gather and use international marketing research for export development, and to segment and target markets, are similarly correlated with export performance.<sup>22</sup>

Planning capability involves several competencies: gathering and testing pertinent information on market and competitive opportunities and threats; allocating and focusing resources accordingly; setting a clear path with metrics, milestones and alternatives for monitoring and course correction; and engaging internal stakeholders to contribute to and execute the plan. It is not surprising, then, that the percentage of SMEs with planning capabilities is thought to be low. For example, in a study of 221 Italian SMEs with between 5 and 250 employees, just fewer than 1 in 4 adopted a systematic approach to international market selection.<sup>23</sup>

The literature further reveals that when certain attributes and guidelines characterize a firm's planning capability, overall export performance increases, often dramatically.

The smallest SMEs appear to perform best as exporters when their diversification is balanced, i.e., when they earn a meaningful portion of total revenues from international markets but are not spread across many of these markets. This concept was tested in a rigorous survey and modeling effort involving 400 Greek firms and 306 English-speaking Caribbean firms, most of which were privately held family-owned enterprises in more mature industries. These firms represented the very small end of the size spectrum; the Greek firms employed, on average, 50 employees, while the average for the Caribbean firms was 38. The research bore out the central thesis that for

small firms, the optimal balance appears to be fairly high export intensity with concentration in relatively fewer foreign markets.<sup>24</sup>

The rationale for this finding appears to be that pursuing these dual strategies simultaneously enables firms to leverage their limited resources, expertise, and capabilities while acquiring market-specific knowledge. In contrast, attempts to serve a very large number of markets results in dilution of resources and effort. Meanwhile, marginal or limited commitment to overseas sales vis-a-vis domestic opportunities does not allow the firm to engage in active learning and relationship building central to export survival. In sum, scatter-shot, ad hoc, and/or sporadic strategies typically do not lead to consistent success.<sup>25</sup>

Second, among both small- and medium-sized SMEs, it appears that the best exporters tend to be entrepreneurial in their planning. This means that high-performing SME exporters are most likely to have planning capabilities that specifically enable them to assess and shape new opportunities, whether or not these opportunities are international. In particular, firms that employ two specific types of entrepreneurial planning should have better odds of export success. According to one study, the attributes of entrepreneurial decision making that matter most are risk taking (defined as the degree to which a company has historically undertaken high-risk projects with potentially high returns, and/or has otherwise invested in bold action) and proactiveness (the degree to which the SME initiates action and seeks competitive leadership).<sup>26</sup>

This research outcome is supported by the more general finding that when leadership exhibits positive attitudes towards risk and competitiveness, firms tend to experience superior export performance.<sup>27</sup> Again the reason seems intuitive: Relative to large companies, SMEs lack market power, critical information on foreign markets, assets and managerial capabilities, and more. This increases the uncertainty of internationalization for SMEs and makes it a higher risk strategy. Thus, those SMEs with an organized capability for managing risky initiatives, monitoring progress, and systematically allocating resources, by and large fare best.

Third, there are conflicting viewpoints on whether SMEs from emerging markets should target developed or developing markets. The firm-level analysis is only starting to differentiate rigorously between inter-regional sales, which for certain LAC SMEs may provide an opportunity for their initial export program, and extra-regional sales. Nor have factors such as ethnic affinity been fully examined. With that caveat, one research team



posits that at least the smaller firms from smaller economies should focus on developed markets.<sup>28</sup>

The observation of the research team, which is in line with emerging work by leading management theorists, holds that many emerging markets, including India, China, Thailand, Turkey, and South Africa, require intensive product and channel changes in order to meet uniquely localized applications and sales outlets in the face of what can be high price sensitivity. Setting aside sometimes thorny regulatory and procedural issues, even the largest players already serving these markets find issues of functionality and channel mix extremely difficult to ascertain, whether or not they face the additional constraints of cultural differences.<sup>29</sup> Finally, with more than 20,000 multinationals operating in emerging markets as of January 2011, competition may be no less stiff than in developed export destinations.<sup>30</sup> Taken together, this logic would mean that selling to certain emerging markets outside the region adds layers of complexity to what is already the complex process of internationalization. At least for those LAC SMEs just starting out on their export trajectory, it can be riskier to export to India or China than to the United States.

On the other hand, case studies on four Argentine sectors emphasize the demanding and competitive nature of developed economies. The researchers believed that entering developed markets with differentiated products required potential Argentine exporters to make substantial investments in product and marketing upgrades for which they had insufficient knowledge. They concluded that most Argentine producers chose not to attempt exports to developed countries for these reasons.<sup>31</sup>

Furthermore, a quantitative study of firm-level determinants for Brazilian exporters in 2000–2009 puts the latter observation in a broader context. These findings showed that once firms overcame the initial burden of sunk costs in exporting to the US and the EU, export survivability was very similar to sustainability within MERCOSUR and neighboring countries.<sup>32</sup> That is, after the initial assessment, set up, and investment, Brazilian firms were no less able to meet the demands of selling in developed economies than in their own backyard.

As such, the core planning issue does not appear to be one of developing versus developed markets per se. Rather, planning must focus on market access and market complexity in terms of the SME's experience in exporting. For smaller and less experienced LAC SME exporters (at least), it appears that these firms should benefit from targeting markets they can

more easily understand and accommodate in such areas as product specifications, pricing, and sales structures. For example, it is often easier to manage product requirements that are similar to those in the domestic market and thus require relatively less initial product adaptation for exporting success. Because geographically and/or culturally proximate markets often provide such a close-in opportunity, this lens also implies that intra-regional opportunities can serve as important first steps for many LAC SMEs.

For some companies, export performance and experience gained by initially serving less complex markets can result in learning that allows for expansion to more demanding markets over time. As in the Brazilian study above, an analysis based on a decade's worth of data for Colombian firms showed that once these firms had successfully penetrated other Latin American destinations, they were 24 percent more likely to succeed in reaching at least one larger OECD market.<sup>33</sup>

### ***Success Driver #2: Product Strategy and Adaptation***

In 2012 the Inter-American Development Bank collected working papers written by different country experts on new export activities in the region. The resulting book, *Export Pioneers in Latin America*, was based on the inputs of nine teams in seven LAC countries who examined more than 30 successful cases. In his introductory chapter, editor and researcher Charles Sabel observes:

“The ‘world market,’ as revealed in these studies... is not a market of things the whole world wants, but rather an institution for connecting very particular consumers with producers specialized in the particular things those consumers (come to) demand...

*In order to find at least one successful export, it is necessary to coordinate the construction of an engine capable of searching among many possibilities. To continue succeeding, that engine must be continuously refurbished so it can search under changing circumstance... (emphasis ours).”<sup>34</sup>*

These studies demonstrated that the process of continuous exploration was the same regardless of whether existing products are customized for export or developed as entirely new offerings. The studies found the same results in the often considerable differences in industries and end customers.

The common thread was the use of an “organizational export engine” capable of optimizing the match between external market opportunity and a firm’s offerings.

This insight is confirmed by quantitative evidence showing that an SME’s ability to offer a complete product mix in export markets is positively correlated with export performance. Here, completeness refers to the full gamut of product features and support that will match it to consumer needs—product quality, design, warranties, pre-sales, and after-sales service.<sup>35</sup>

The product capability requires that SME exporters determine both where to compete (which offerings for which customer segments) and how to specify its market offering in order to compete (how to adapt the offering). This is not a one-time activity. The firm must learn from its own process of trial and error and continue to set new, iterative goals. Moreover, decisions faced regarding product run in parallel—not sequentially—with the learning that happens when the determination of where to compete critically informs and changes the issue of how to adapt the market offering.”

Product strategy and adaptation demands the following firm competencies:

- Organizational skills to gather multiple sources of market intelligence, profiling customers and their product needs, and scanning for competitive activity.
- Analytic skills to assess the quality of information and prioritize opportunities.
- Self-assessment skills to pinpoint the firm’s areas of specialization, i.e., its particular strengths and weaknesses in serving, attacking, and supporting a specific market space (also called “self-discovery”).
- Strategic vision and ability to plan for structural barriers that will deter competitors and imitators once the firm has won market share.<sup>36</sup>
- Product development skills to integrate marketing, engineering, and production so as to define, test, create, and scale product modifications.

Some observers believe that product strategy and adaptation capability is particularly important for developing country SMEs that export to developed markets, since this requires that firms frequently upgrade the quality of their products.<sup>37</sup> As discussed above, recent work on the difficulties of product penetration experienced in India and other complex, fast-changing

emerging markets—including by large domestic firms in these markets—highlight that the issue is broader. Certain markets and certain customer groups are highly exacting in their demands, and across multiple product features.<sup>38</sup> To the degree that these expectations and needs differ from those in the LAC home environment, the SME exporter must be that much more nimble in its product strategy.

It is also relevant that firms seem more likely to start exporting after improving or changing their products,<sup>39</sup> whether because product development is a prerequisite for new market entry and/or to recoup product development costs through greater scale. At the same time, export expansion is equally impacted by the firm's ongoing ability to adapt product to needs in export markets. Extensive data from Europe (9,480 SMEs in 33 countries) illustrates both points: nearly one-half of all internationally active SMEs surveyed had introduced new products or services in the three years prior to the survey, versus about one-third for the group as a whole. One-third of the SMEs that developed products or services by themselves did so because they judged these innovations to be necessary for entering foreign markets, while another 22 percent of SMEs that developed products or services by themselves did so as a consequence of activities in foreign markets.<sup>40</sup>

Similarly, statistical analysis of data describing 99 US manufacturers in the medical and dental equipment sectors revealed the strongest export success among those firms that designed their products with a view toward serving international markets rather than domestic markets. Further, international design orientation correlated positively with export intensity.<sup>41</sup>

Management's ability to pick and invest in product winners is pivotal to export expansion. In a study also referenced in Chapter 2, data analysis on Brazilian multiproduct, multi-country exporters, which are typically medium-sized and large firms, underscores that only a few top-selling products accounted for the bulk of a given firm's exports in a market. Moreover, it was the best performing products (highest sales) that were exported across multiple destinations.<sup>42</sup> A related pattern was exhibited in a comprehensive dataset that included nearly all French exports worldwide, or over 2 million shipments covering 10,072 products in 229 destination countries/territories. This evidence showed that French exporters substantially skewed their export sales towards their better performing products in markets where they faced tougher competition.<sup>43</sup> In a similar vein, analysis was conducted based on a dataset covering 85 percent of Mexico's industrial input during the period from 1994–2003, which immediately followed

### **Driving Product Adaptation through Ongoing Customer Intelligence: The Experience of Uruguay's ARTech Consultores S.R.L.**

ARTech Consultores was founded in Uruguay in 1988 by two computer engineers specializing in database programming. Both men had the requisite internationalized background, having consulted in Brazil and the US. After some trial and error, they hit upon what proved to be an exceptional business strategy: creating tools to enable consultants to develop database applications more efficiently.

From their first software release of a product they called GeneXus, in 1989, ARTech went on to sell 350 copies in 1991 throughout much of the region, earning foreign revenue of approximately \$250,000. Within a decade, by 1997, overseas sales had grown to \$60 million (\$10 million in license fees and \$50 million in related services). Within about 20 years, in 2007, ARTech had sold 50,000 licenses in several dozen countries, and exports were providing more than 90 percent of firm revenues.

The software industry is what researchers call a "platform producer." As with the cell phone and aircraft industries, the performance of the overall product depends crucially upon the performance of a series of independently produced and rapidly developing subsystems. In the software industry, strong relationships with key software developers are essential to testing and selling products. It is these developers who are closest to and thus can best understand the end customer, because they design the applications that end customers buy.

ARTech addressed this challenge head on with the establishment of its Solution Partners Program, a community of developers of GeneXus-based applications. A developer in the community with a substantial GeneXus customer base receives technical support, a chance to participate in beta-testing, and special discounts from ARTech. In exchange, ARTech receives a continuous flow of information on bugs and possible feature improvements. Further, within a group of about 150 Solution Partners, 10 are designated "level 1" partners, who provide a rich source of knowledge on next-generation products for market niches.

An ARTech manager explains: "If a local firm... has a problem in Malaysia... we send a person... to solve that precise problem. And this helps us to achieve GeneXus product optimization because it shows us a shortcoming. Despite our internal tests, with thousands of users, unexpected events can occur; this is the market filter."

*Adapted from Software Discovery in Uruguay: Public-Private Solutions to Coordination Failures, Michele Snoeck and Lucía Pittaluga.*

the establishment of NAFTA. The evidence showed that Mexican firms expanded their exports of better performing products (highest market share in terms of company export sales) significantly more than their worse performing exported products.<sup>44</sup>

### ***Success Driver #3: Relationship Development with Channels and Customers***

Deep, effective relationships with channels and customers have long been recognized as pivotal to export success. In a widely referenced meta-analysis that integrates 33 individual export studies from multiple approaches, datasets, countries, and sectors, the authors repeatedly found that excellent relationship skills were critical to exporting success. The results of deploying such skills were defined as achieving closely managed, trust-based, personal and long-term partnerships, and specifically with distributors and customers.<sup>45</sup>

The relationship development capability is particularly important for improving the export performance of LAC SMEs. Because these firms generally exhibit a pattern of rapid entry and exit of export markets, this tendency discourages the development and leveraging of value-adding relationships. Of course, small trials are a way to encourage SMEs to get in the game and begin learning, even if the lessons are saved up to reenter another day. However, at some point a regular commitment to exporting must take place in order to build towards repeated success. The dividends from effective business relationships simply cannot emerge when the relationships continually end before they deepen.

Adding to the importance of this issue is the methods by which SMEs from developing countries sell into export markets. Few have the resources or know-how to market directly to a mass market. Instead, these SMEs pursue one and/or both of two go-to-market strategies: they sell through sales agents and other distributors, who then manage most if not all marketing activities in the end-market; and/or they sell primarily to a concentrated group of large buyers. These strategies are particularly used by SMEs at the smaller end of the spectrum and/or those that have not yet achieved multiyear export sustainability. In either of the strategies, the capability to build effective relationships over time predominates. Export entry is primarily affected by the identification of promising channel partners and customers, while export survival and success are highly dependent on the ability to strengthen these relationships over time. What is involved in relationship development at the intra-firm level? To address this question, we first examine the multifunctional roles that both customer and channel relationships play in the export process. Both sets of relationships do more than provide the vehicle for export sales. They also enable the SME to tap essential market knowledge and simultaneously generate market awareness. Further,

channel partners may reduce the overall costs of penetrating and building positions within a foreign market, especially at lower volumes; these costs might otherwise preclude the SME from exporting.

In the case of strategic alliances and/or strategic distribution consortia, both of which apply somewhat more frequently to larger SMEs than to their smaller counterparts, the SME's partner may also function as a source of technology and/or capital. It appears that stable relationships with such key alliances trigger a higher level of professionalism and accountability in the SME, as demonstrated in a study of family-owned Spanish export firms.<sup>46</sup>

Against this background, it becomes clear that the key goals of relationship development are enhanced communications and commitment. And indeed, research shows that high-trust, high-commitment "channel bonding" decreases opportunistic behavior among channel members, reduces the cost of negotiating and enforcing contracts, and increases the likelihood of returns from product adaptations and marketing expenditures.<sup>47</sup>

A high capability to bond with channels requires several skills that allow the firm to:

- Find mutually beneficial relationships via due diligence.
- Set performance metrics for accountability and shared success.
- Extract ongoing market feedback and intelligence as a primary source of information to provide strong offerings and keep them competitive.
- Communicate the key advantages of the offering.
- Build trust despite cultural and geographic distance.
- Deepen relationships over time.

These are virtually the same sets of competencies required for customer relationship development when an SME sells directly to individual large buyers. Leading marketing theory emphasizes that initiating strong relationships requires the gathering of market intelligence via information sharing, also known as "market sensing"; communication of product benefits in the context of customer needs; and prioritizing issues trust.<sup>48</sup> Moreover, deepening customer relationships require adaptive marketing approaches and strategic marketing capabilities, both of which are positively correlated with export performance. Examples of the latter include the ability to respond to marketing forces, the ability to adapt the marketing mix over time, and the ability to adapt pricing as a penetration strategy.<sup>49</sup> Throughout, frequent

### **“Channel Bonding” Key to Exceptional Export Success among Australian SME Winemakers**

The Australian wine export industry illustrates the principles of “channel bonding” to a tee. Australia has led the world in a revolution across the international wine landscape. Two decades back, the production, distribution, and marketing of wine was the preserve of European producers. Australia’s average wine export price rose 52 percent in just five years in the mid-1990s, compared to a global average of 20 percent. Amid a rise in New World exports overall, Australia has risen to be the fourth largest exporter (behind Italy, France, and Spain) and second only to Italy if EU trade is excluded. These rankings held as of 2010 and 2006, respectively. Thus a focus on the most successful among these firms provides a unique view into what can create sustainable (and even explosive) export success.

In-depth interviews of these high-performance exporters reveal an almost fanatical attention to their agent relationships. Top performers were defined by management commitment, export intensity of over 40 percent, and annual increases in export sales of roughly 30 percent. These high performers placed critical importance on close, trusting, and personal relationships with their agents. They selected agents with limited client lists who would provide their own products with maximum attention. They understood that relationships required constant nurturing over many years, and they invested accordingly, traveling at least twice annually to work directly with the agents.

*Sources:* D. K. Aylward, “Global Pipelines: Profiling successful SME exporters with the Australian wine industry” (2006) University of Wollongong School of Business Research Online; Research and Markets. (2010) “Market Analysis – Competition in Global Wine Market” (summary). Retrieved December, 2010.

customer contact is a key determinant of export performance, as a study of 165 Dutch SMEs demonstrated.<sup>50</sup>

Despite casting light on these general principles, existing studies on relationship development fall short on a number of points, including the lack of consistent terminology, misalignment with accepted and influential business scholarship, and an inability to differentiate between strategic and tactical decisions and activities. Nor is there much work that provides actionable insights concerning export entry and stability of regional SMEs. Examining the drivers of success, and specifically as they apply to the region, would appear to warrant additional research.<sup>51</sup>

#### ***Success Driver #4: Production and Delivery***

The trust of channels and customers will make or break a SME’s export initiative. Yet trust is tenuous in today’s fast-moving markets—all the more so



for small firms that are relatively unknown in a target market, and often have little track record. Sustaining trust is even more critical for LAC SMEs because the firm's home country may not have a reputation for quality goods related to the SME's offerings.

For the firm's core overseas relationships, product delivery is the essence of making good on commitments. A study exploring the requirements of US buyers in the footwear and bicycle industries found that regardless of the buyer's place in the distribution channel or market niche, virtually all of these firms had minimum product criteria concerning price, quality, and delivery. Meeting specific supply volumes when agreed upon, for each and every delivery, was of paramount importance, as even slight delays could result in substantial extra costs and losses to the buyer.<sup>52</sup>

The study further revealed that US buyers specifically prefer to build long-term, stable, and direct vendor relationships as a way to reduce their risk, promote mutual learning, and increase efficiency as time goes on. Thus, SMEs' opportunities in constructing production and delivery capability are not limited to creating an international competitive advantage per se, although in some sectors this can be true. Rather, this capability is about consistently understanding and meeting the expectations of channels and customers in order to maintain these relationships.

Experiences of firms from different world regions illustrate this principle. Factor analysis of a survey completed by 456 Sri Lankan SMEs in different sectors ranked limited production capacity as one of the top five barriers to exports.<sup>53</sup> Similarly, quantitative review of Zimbabwean manufacturing SMEs showed that lack of capacity to produce the required quantities prevented SMEs from exporting to the EU.<sup>54</sup>

Delivering product of specified dimensions, volumes, and quality at set delivery times is more than a capacity issue. It is strongly linked to other capabilities discussed in this chapter, especially relationship development and technology/innovation. The firm must be able to regularly and reliably gather and understand requirements as its channels and customers define them (based on relationship development), and it must be able to organize and then iterate production so it meets ever-changing demands.

There is evidence that exporting SMEs more often pursue more extensive process innovations than do their domestic-only counterparts. This is thought to be a response to the stringent demands placed by foreign markets on SMEs' production and supply chains. For example, survey data on European SMEs show that SMEs with concrete plans to export are nearly three

### Process Upgrading and the Worldwide Export of Colombian Flowers

Floramérica stands out as a remarkable historical case among LAC SME exporters. In 1969, the firm not only initiated Colombian floral exports to the US; it also played a defining role in disseminating world-class standards, which resulted in a much larger and more sophisticated domestic industry.

Floramérica's initial success depended on adapting US production methodologies to Colombian conditions. The company began by importing rootstocks that could be planted at optimal times and produce what US customers considered to be desirable colors. In a departure from the Colombian practice at the time, the company followed the US approach of building abutting greenhouses to better conserve productive land and maintain set temperatures. Responding to feedback gathered by its US distributors and wholesalers, it packed its flowers in small boxes with assortments of seasonal colors.

Next, the firm responded to problems as they arose. For example, because the lack of boron in native soil proved detrimental to carnations, the firm applied large quantities of magnesium and calcium to its land.

Each of these strategic actions reflects the deliberate exchange of market insight and an ongoing process of improvements.

*Adapted from Arbeláez, Meléndez, and León 2007 – The Emergence of Fresh Cut-Flower Exports in Colombia.*

times more likely than their counterparts to introduce process innovations that they believe are new to their sector in their home country.

Export sales require different logistics requirements from those in the domestic market. They include transportation, regulatory compliance, demands for certification and customs documentation, and language skills. The ability to ascertain and meet these requirements represents a steep learning curve for the first-time exporter, and to a large degree, the current exporter exploring new markets. For this reason, some export promotion agencies focus on training and education in these areas. While such support seems logical, its results have not been well researched.

### #5: Technology and Innovation

Holding size constant, it appears that more successful exporters have stronger innovation and technological capabilities. This is the finding of econometric investigations of firm-level data from multiple countries and diverse sectors, including several specific to developing markets. In general, this body of work substantiates a causal relationship between a firm's

### **Raising the Bar in Production and Delivery: SME Exporters in Argentina's Light Ship Building Sector**

In Argentina's SME-dominated light ship building industry, production models for domestic-oriented firms and export-focused companies differ sharply.

Employees of domestic-oriented firms view themselves as craftspeople, building custom product for specific members of the river boating community, with whom they share a common lifestyle. Because they provide a broad portfolio of product, they achieve very little in the way of scale economies.

In contrast, export-oriented shipmakers design new products to satisfy niche demands in foreign markets. Production is standardized and documented to facilitate technical support and minor servicing abroad. In the export business model, firms employ production specialists, many of whom have been trained overseas and understand the precision with which boats are designed.

Exporters make frequent improvements in production processes, quality, and design, and leverage the potential of new shipping materials. These improvements are entirely based on publicly available and codified technical information. Prior knowledge is not required, but employees must have the ability to read technical information in English and a sufficient level of engineering skill and capital to apply it. As one commercial manager states, "This is an industry that has no secrets at all. Everything (you need to know to build a boat) is published. There are no technical or intellectual rights, either."

While this activity is cutting-edge for Argentina, it is common throughout the world and has not been necessary for export success. For example, none of the Argentine ship exporters reach the scale to implement mass production, in contrast to their Italian competitors; however, they have integrated CAD technologies into their processes.

Compañía Constructora de Embarcaciones (CCE) is an Argentine pioneer in exporting light ships. Launched in 2000 precisely because CCE's founder deemed the domestic production model flawed, the firm has expanded its export sales through a three-pronged strategic focus that emphasizes product strategy (serving an under-served segment and providing quality-assurance services), distributor strategy (creating deep relationships with channels known to represent tier-one international product), and production strategy (standardizing production and meeting world-class design standards), along with penetration pricing (pricing below cost to gain initial overseas market share).

Upgrading and standardizing production demanded worker skills that had not previously been used by Argentine shipmakers, including industrial and naval engineers. Later, CCE secured certifications from the European Economic Community and the Registro Italiano Navale. CCE sells to the Mercosur countries, Trinidad and Tobago, Spain, the Netherlands, the UAE, and the US. Exports reached \$500,000 in 2005.

*Adapted from Artopoulos, Friel, and Hallak, 2010. "Challenges of Exporting Differentiated Products to Developed Countries: The Case of SME-Dominated Sectors in a Semi-Industrialized Country."*

technological capabilities and export entry, and in some cases export performance.<sup>55</sup>

A sample of these results includes the following:

- For Vietnam, a probit model based on a 2005 firm-level survey of 2738 SMEs across sectors showed that process innovation, product innovation, and modification of existing products are each important determinants of the probability of exporting.<sup>56</sup>
- For China and Sri Lanka, econometric analysis of the 2003/2004 World Bank Climate Surveys for 558 clothing firms of all sizes concluded that the acquisition of technological capabilities is positively associated with the probability of exporting.<sup>57</sup> Separate firm-level statistical studies on China (213 industrial firms) and Sri Lanka (205 clothing enterprises) reported that export growth and export share, respectively, were positively influenced by indices of innovation capability.<sup>58</sup>
- For Spain, regression analysis of data across 14,500 manufacturing firms of all sizes over 1990–1998 (1600–2000 observations for any given year) suggested that product innovation activities positively affect the decision to export.<sup>59</sup>
- For Thailand, regression analysis of data from in-person and phone surveys of 111 SMEs in the plastics industry demonstrated a positive relationship between improvements to the manufacturing process and also in product design with export intensity and export growth; there was a weaker relationship with export diversity.<sup>60</sup>

At a general level, technological innovation is a determinant of both firm-level comparative advantage and labor productivity. Detailed analysis by IDB researchers of micro data from innovation surveys in six Latin American countries (Argentina, Chile, Colombia, Costa Rica, Panama, and Uruguay) found that firms that invest in knowledge are more able to introduce new technological advances. Similarly, the analysis found that firms that innovate have greater labor productivity than those that do not.<sup>61</sup> The study's design took into account the oft-observed fact that firms in developing countries rarely undertake formal R&D activities at the edge of the technology curve. Rather, they focus on the difficult processes of acquiring and absorbing new technologies efficiently.<sup>62</sup>

There are at least three explanations for the link between technology-related innovation and exporting. First, strong technological capability often

leads to process innovation and/or product innovation, which allows SMEs to meet demanding requirements from overseas customers and channels.<sup>63</sup> Second, on balance, companies with greater presence in global markets require more aggressive technological capabilities, indicating a direct link between technological knowledge and competitive ability.<sup>64</sup> Third, a virtuous cycle may also come into play; success in one export market enables greater technology-related investments, which in turn may lead to greater penetration of existing foreign markets and/or penetration of subsequent export markets.

Technological capability is closely linked to several other capabilities which exporting demands. On the one hand, it is a direct reflection of the growth-oriented and entrepreneurial planning processes that precede investment in uncertain levels of return in order to pursue superior performance. Meanwhile, innovation is a key enabler of enhanced product design and change (product strategy and adaptation) and often the foundation for operational processes that drive consistent, high-quality product delivery (production and delivery). Yet SME investments in this capability can be hindered by many elements, among them, relative lack of economies of scale, lack of sophisticated management, lack of pressures to upgrade in the home market, and a dearth of available capital and financing.

Against this backdrop, it appears critical that a larger number of LAC SMEs develop the requisite technology capability to compete successfully in foreign markets. This raises a pivotal question: what is involved in technology capability formation for emerging market SMEs?

In a synthesis of case studies covering the export-driven East Asian miracle, Ernst, Ganiatos, and Mytelka address this question with depth and insight. Their framework is derived from findings spanning the 1960s through the mid-1990s in five countries (Taiwan, Korea, Thailand, Indonesia, and Vietnam) and four sectors (textile, electronics, apparel, and general manufactured goods). Many of the companies investigated began as SMEs. As a group these cases are highly informative due to several common characteristics that cut across the firms' distinctive characteristics: the speed at which these firms entered export markets, the long-term stability of their export growth, and their ability to stay at the forefront of their industries in terms of export success despite the emergence of new competitors and competitive pressures.<sup>65</sup>

This work peers "under the hood" at the process by which technology is acquired, absorbed, and operated for benefit. Conclusions for LAC include the following:

1. In the vast majority of situations, meaningful innovation is based on regular, ongoing, and incremental upgrading of technologies that already exist in the market, or a fresh combination of existing technologies. In other words, successful technological innovation is a process that is iterative, cumulative, and based on learning-by-doing.
2. Radical innovation, which most often requires knowledge and organizational procedures that are dramatically new for the individual firm, is less common and harder to get right.
3. Technological knowledge is largely embodied in the skills of a firm's people, in its behavioral patterns, and in organizational structures and procedures.
4. Technology adoption demands organized interactions across multiple actors via continuous practices that are complex to manage. Internally, this involves marketing, production, R&D, and design functions. Externally, the firm interacts with the producers and users of a given technology, which include academic institutions, materials producers, component suppliers, final assemblers, and customers.<sup>66</sup>
5. Technology capability formation equates with technological learning. This special kind of learning is built on two necessary and complementary elements: Public, or codifiable, knowledge (i.e., generic engineering, scientific, and management details along with practitioner methods and principles for applying these to specific problems and circumstances) and tacit knowledge which differentiates each firm and which is harder to exchange among them (i.e., organizational routines, expertise, and skills which are embodied in and regularly refined by a firm's teams).
6. Technology capability formation must deal with both the codifiable and tacit sides of the equation. On the one hand, SMEs must access and acquire public knowledge, which in developing markets often consists of imported technology and English language documentation. On the other hand, SMEs must invest in a relatively costly and time consuming development of tacit capabilities and the engineering-related skill sets that allow it to use, adapt, particularize, and improve upon the generic knowledge.
7. The authors exploring the export successes that drove the East Asian miracle conclude that weak intra-firm technological formation capabilities constitute the major barrier to the diffusion of technology in developing countries.

### **Technological Formation in the Era of the East Asian Miracle: A Gradual Confluence of Increasing Innovation and Export Expansion**

T2, a diversified textiles exporter from South Korea began in the 1960s as a small weaving company using yarn imports from a Japanese trading company. Five years after T2's founding, this same Japanese trading company began to sell T2's fabric blends in Indonesia and the Middle East, managing all marketing and distribution.

Fast forward another six years and, in response to domestic competition, the company built its own cotton spinning mill using Japanese machinery and assistance, once again from the trading company. These and other backward linkages moved T2 from a fabrics producer to an integrating spinning, weaving, and dyeing company able to develop new yarns and new fabrics to meet evolving customer demand.

By the time changes in the Indonesian market of the 1980s forced T2 to look elsewhere for export sales, the company was well-positioned to brand its products, eventually establishing 16 distribution and marketing offices in North America, Europe, and Asia. These new markets accounted for roughly three quarters of its total exports.

*Adapted from Ernst, Ganiatsos, and Mytelk, editors. Technological Capabilities and Export Success in Asia. Routledge Studies in the Growth Economies of Asia. (1998).*

### **Innovation in the Service Sectors: A Blurring of Lines between Process and Product Innovation**

The service sectors are of critical importance in LAC, where the services share is much higher than in developing Asia and Africa, and closer to that of developed economies. By one estimate, services represent about 66 percent of total world value-added, and 75–80 percent of that of developed economies.<sup>a</sup> The same source pegs this number at 48 percent for Asian countries, 45 percent for African countries and 62 percent in LAC. In the Caribbean nations, services account for 74 percent of value-added. Moreover, services are growing at a higher rate than industry in every LAC country except for Peru and Ecuador.<sup>b</sup>

These inherently high levels of growth, along with an accelerating trend towards integration of services with physical goods, make it imperative to understand how service businesses can increase innovation and how they compare in this regard with non-service industries. This box provides an overview.

Innovation within the various service sectors brings with it distinctive obstacles. At a theoretical level, services can be viewed as either stand-alone or embedded activities. Tourism and public services fall into the former category, whereas services that are integrated into manufacturing and agriculture are part of the latter; manufacturing goods

*(continued on next page)*

### **Innovation in the Service Sectors: A Blurring of Lines between Process and Product Innovation** *(continued)*

in particular are increasingly accompanied by new value-added services. Each dynamic brings with it different growth and internationalization opportunities, which are only further stimulated by the fact that certain services (such as engineering, consulting, and marketing) are global in nature while others remain highly localized. Moreover, problems with input and output data raise questions about measuring, thus making it difficult to fully explain sector productivity.

A number of key market failures in particular impede innovation by SME service firms. Some of these include appropriability, or “free-riding,” which discourages potential pioneers due to ease of imitation and insufficient protection of IP; widespread information asymmetries within sectors that vitally depend on knowledge for coproduction; and heightened constraints on access to financing. Also thwarting possible innovation are systemic failures endemic to the services, such as a dearth of high-caliber human capital with relevant skills and of strong business networks as the routes for knowledge transfer.

Because services are intangible, the lines between process innovation (how to deliver) and product innovation (what to deliver) are hard to disentangle. At its root, service innovation focuses on new experiences and solutions whether in interaction with the customers or business partners, in defining new revenue or operating models, or in relation to a tangible end product. This opens up a much wider set of conditions than in goods innovation.

Yet just as with goods, the impetus for, and the shape of, innovation may come from any number of sources: clients, users, suppliers, new technologies, or new in-house insights. Consider retailing. Client-driven innovation has promoted green and organic products; supplier driven innovation has led to new scanning and storage systems; and new technologies have made possible e-commerce / online matchmaking and bid fulfillment.<sup>6</sup>

IDB case studies in the region provide a glimpse into the conditions that make possible effective services innovation. These cases cover several countries—Argentina, Brazil, Chile, Costa Rica, Jamaica, and Uruguay—and several sectors—logistics, mining, transport, offshoring, distributive trades, rural tourism, software, retail, outsourcing, creative services,

In sum, the very technological capability that is necessary for exporting is not contained in machines or manuals. In contrast to conventional wisdom—and particularly for countries that may be farther from the technological frontier in a given industry—technology capability formation is not solely driven by hard metrics such as number of patents or level of investment in R&D. Instead, it is fundamentally a process of organized learning that is nonlinear, with necessary and continuous inputs from multiple categories of participants, and centered in diverse and cumulative skill



and biotech. The majority of firms studied were SMEs. Lessons that emerged include the following:

1. Service innovation often addresses a crisis of some nature at the level of the firm, client, or economy. Piracy in Jamaica led some firms to produce live music events and others to develop entirely new products, such as culinary services. The intense pressures of the 2008 global downturn led Costa Rican hotels to increasingly focus on sustainability to differentiate branding and attract a higher income customer still able to travel overseas.
2. In many service sectors, innovation can be highly dependent on training to expand the source of skilled human capital, whether via business associations, relationships with suppliers, government initiatives, and/or public-private partnerships. This includes the creation of pro-innovation cultures and of innovation management programs.
3. Service innovation may require trade-offs between characteristics of the total offering, as in the case of the hospitality industry. Yet other innovations (such as water and energy efficiency mechanisms) result in quantitative operational improvements.

Despite difficulties in determining and obtaining hard metrics, qualitative insight from the case studies indicated that service innovation pays off. Firms reported a range of impacts, including higher employment levels, improved internal capacity to innovate, increased differentiation, and access to new clients and new markets.

*Adapted from Rubalcaba, Luis, "Innovation and the New Service Economy in Latin America and the Caribbean," (2012) Inter-American Development Bank.*

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and knowledge development at the level of the individual firm. These firm-specific learning processes are the decisive prerequisite for successful technology capability formation.

#### **D. The Importance of Learning**

In closing this discussion of specific export success factors, we find that an overarching theme has emerged: by far the majority of the enabling capabilities are continual and learning-based. They demand not only that SMEs

move up a steep learning curve, but also that they maintain a long-term commitment to exporting as a means of generating new revenues and profits. As SMEs export successfully, a virtuous cycle sets in. The learning that firms experience internally and the exposure to new information and practices they gain externally combine to help firms develop an increasingly sophisticated approach to exporting.

Although additional research would help pinpoint how these benefits accrue and precisely how they are triggered, much is already known. With success, exporters form higher value and denser information networks; they innovate more frequently and more rapidly, on both product and process dimensions; and they create more effective and efficient marketing and distribution mechanisms.

All of this complements the positive impacts, shown in Chapter 3, between firm learning and the reduction of successive sunk entry costs. This impact is particularly pronounced when firms expand their export initiatives in markets where they already have established an export presence or with offerings they already export.

### III. A Special Case: The Born-Global Firm

It is generally assumed that SMEs spend many years building up their competencies and comparative advantages serving the domestic market before venturing overseas, after which they build export sales one market at a time. This view reflects the majority-case scenario, a pattern of internationalization that holds for firms in most sectors and domestic markets.

However, the jump from domestic to global markets can take place another way. In the case of the born-global firm, the SME internationalizes in the first years following inception. While starting points vary, most observers consider a firm to be born-global if exports begin, rapidly, and in a sustained manner, within the first three to five years of its founding.

Born-global ventures are typically high-tech, high-design, high-service, and/or generally knowledge based. Thus, lessons from this phenomenon may be of significance in emerging knowledge driven sectors across the region.

Well-known born-global firms include Skype (Internet and software), Zara (clothing), and Cochlear (medical devices). The sometimes-striking performance of these born-globals, or “micro-multinationals,” opens up the possibility of supporting firms that prioritize internationalization from the start. But to do so, we must first determine how this path differs from what

has been considered the norm. With rare exceptions, born-global enterprises share the following key characteristics:

- Their products are distinctive, emphasizing superior quality and leading-edge capabilities.
- They pursue strategies with high structural barriers to entry (built-in ability to avert future competition) which should protect the business going forward.
- They roll out first by targeting niche markets with similar needs and demands no matter the location, then scale to a wider audience.
- Their founders and senior management view foreign markets as the core of the business, not as an extension or second thought.
- Their founders and senior management boast highly international backgrounds.
- As soon as they enter export markets, they are very active, skipping over any exploratory phase. Put another way, they are masters at reaching new markets rapidly.

Yet born-global companies face unique support needs, especially in the areas of managerial capacity and financing. A born-global firm possesses even higher capital and management needs than the traditional internationalizing SME. They must fire on all cylinders at once, establishing distribution and marketing in different countries simultaneously. Anything less will tip off potential competitors to the emerging opportunity without capturing enough of a strategic lead and customer base to protect the new business. The level of talent to manage this complexity can be scarce. Meanwhile, as start-ups, it is difficult for them to access traditional capital sources to fund the high costs related to scope, especially as they typically have few collateralizable assets. Venture capitalists can be less able to assess born-globals, and even less willing to fund growth plans with significant overseas exposure.

Insights from the born-global experience may be of particular importance to the region's smaller economies. Worldwide, small economies such as Israel, Estonia, Belgium, Denmark, and Australia are known for a higher share of born-global firms as a percentage of their early stage SMEs. In all countries, born-global firms constitute just 18 percent of young enterprises and about 1 percent of all enterprises. In contrast, almost 50 percent of the start-ups in Finland, Norway, Sweden, and Denmark were found to be

exporting within two years of inception.<sup>67</sup> Even more striking is the case of Norway. Norwegian SMEs founded in the 1970s averaged 27 years to start exporting, those founded in the 1980s averaged only two years from start-up, and those founded in the 1990s were exporting after just one year! The message is clear. Because small economies cannot be relied on to provide sufficient demand and scale for cutting-edge offerings, their high value-added start-ups plan from the start to capitalize on global markets.

Examining key elements of how born-again companies operate and overcome exporting challenges can also be useful to SME exporters that follow the more sequential pattern of internationalization. For example, born-global firms are renowned for leveraging communications technologies in order to facilitate deep engagement with strategic partners, whether distributors or suppliers. They prioritize the ability to initiate and manage collaborative partnerships, and they are far more likely than other internationalizing SMEs to share resources, risks, and returns with these partners. Born-global firms also move with speed and flexibility to satisfy customized product requests from customers, maximizing what is an inherent advantage of small size: adaptability. These approaches, among others, highlight a set of best practices which can be adopted by SMEs in different industries to reduce risk and increase success in penetrating and sustaining profits from overseas markets.

Further insights may be gained from certain variants to the born-global theme which are occasionally found among traditional manufacturing and services SMEs, as opposed to knowledge-driven firms. Like the high value-added born-global, these firms internationalize rapidly and early on. A main enabler to internationalization for these more traditional companies tends to be their access to industry and/or geographic clusters. Such deliberately constructed ecosystems provide concentrated assistance for identifying the specialized and high-caliber human capital required for export success, along with global business contacts.

#### **IV. Conclusion and Policy Implications**

This chapter has examined intra-firm success drivers common to SME exporters, highlighting lessons that have the most relevance for the region's SMEs. Its conclusions are premised on the simple but powerful realization that differentiated performance at the firm-level is what allows some SMEs to exploit country- and industry-specific advantages in international markets. And they do so far more than other firms of equal size, structure, and

### Concrete Canvas Ltd.: A Welsh Exporter Exemplifies the Born-Global Model

Concrete Canvas produces instantly fabricated construction materials using technology developed as a university project. The company was founded in 2004, and by 2012, was selling to over 40 countries worldwide, with exports representing over 85 percent of sales—all with just 16 staff members. Although its first wave of internationalization rode on a sale to the British Ministry of Defense for use on the frontline in Afghanistan, the company's ongoing, rapid expansion is emblematic of the born-global approach: the pursuit of new applications and new categories of clients via continuous product innovation and skillful reputation management.

The 2009 purchase order for military applications in Afghanistan made global markets the firm's focus from the start. Seed funding had come from a group of business angels and a regional development agency two years prior, in 2007, along with a government capital support grant to establish a manufacturing plant in South Wales.

The company first marketed a “building in a bag” that required only water and air for construction. Made for shelter in emergencies, temporary situations, and remote locations, the product was said to withstand high temperatures and many chemicals. Now Concrete Canvas' primary product is a flexible cement impregnated fabric that hardens on hydration to form a thin, durable waterproof and fireproof concrete layer. In layman's terms, it's concrete in a roll; all that's required is to add water. Applications are primarily for erosion control in the civil infrastructure, mining, and petrochemical sectors.

The company seeks out new sites, where it demonstrates how its products meet a variety of needs and environmental conditions. It makes skillful use of publicity. In 2009, the company ran a test in Ugandan refugee camps, working with 22 UN agencies and NGOs in an intensive five-week period. New Orleans became another pilot site in the wake of Hurricane Katrina. In Japan following the tsunami, the company's material was applied to line an amphibious vehicle. Concrete Canvas was also used by Swedish designer Maria Gustavsson to produce designer furniture.

Every year since 2005, the SME has won international awards for innovation. In addition to industry associations, global advertising powerhouse Satchi & Satchi (World Changing Ideas Award) was among the several organizations that have recognized the company. R&D Magazine named the firm one of the 100 most significant technologies introduced into the US market in 2012. In 2013, the company became a finalist in what is perhaps the UK's most prestigious engineering and design competition, the MacRobert Award for Innovation in Engineering.

*Wired Magazine* (UK edition), *BBC News Online*, and *Newsweek* (Poland) all have published articles on the company and its products. In 2013 a *National Geographic* video on Concrete Canvas shelters went viral on YouTube, attracting over 4 million views in four days (and over 5.1 million views in eight months) with its dramatic demonstration of how quickly cement-covered cloths could be transformed into a secure structure simply by two people wetting the fabric.

*Sources:* Concrete Canvas website accessed 19 December 2013; Brian Clark Howard, “Behind the Viral Sensation: Concrete Canvas Goes Beyond Fast-Deploying Shelters” in *National Geographic*, 20 March 2013; Katie Scott, “The Cloth that Hardens Like Concrete” in *Wired UK*, 2 December 2009; “CC Furniture featured by Euromaxx: Lifestyle Europe” – A YouTube vide, produced September 2012; “I Didn't Know That – Concrete Tent” by *National Geographic* – A YouTube video, accessed 19 December 2013.

age. The Melitz model demonstrates that productivity is a determining catalyst for entry into and exit from exporting. This fact underscores why the intra-firm examination is central to thoughtful discussion of SME internationalization. From a related point of view, the intra-firm analysis appears to shed new light on why only a portion of more efficient SMEs enter exporting.

To arrive at a set of proven intra-firm determinants of SME export success and their specific characteristics, we synthesized an extensive set of rigorous quantitative studies and qualitative work, extracting from selected research the themes and findings that proved most consistent and insightful. Further, our approach cross-fertilized the economic and international trade literature with accepted management scholarship in order to maximize alignment with core business theory in such disciplines as strategy, marketing, operations, and organizational strategy.

This methodology led to the identification of eight export success drivers. The research indicates that the more an SME has fully developed each of these drivers, and is able to invest in their further improvement, the greater its chances for success. While there is some variation in emphasis, these drivers appear to be applicable across firms in both goods and services and to the various stages in an SME's export journey from entry to expansion. Because every function and area of decision making of the SME is vital to the export initiative, all eight success drivers are interrelated. Nonetheless, there is little research on correlations and priorities.

We then presented the export success drivers in two analytic categories as part of a conceptual framework borrowed and simplified from the field of business strategy. This framework posits that at any given time, a firm possesses both assets (resource endowments) and capabilities (skills and knowledge that enable the assets to be used). While both assets and capabilities are essential to carving out and sustaining a profitable export position over time, capabilities are particularly valuable in furthering the export agenda. We believe this emphasis on hard-to-build capability development is in line with recent work that points to the need for LAC SMEs to fundamentally transform their business mindsets and practices in order to internationalize successfully.

Insights that have emerged from discussions of each factor include the following:

- **Management:** Prior international background, especially in the SME's export market, and its "market-in" management style that prioritizes customer and competitive factors, are critical to SME export success.

One implication is that these are key parameters to assess an SME's suitability and needs for export assistance.

- **Capital:** As detailed in Chapter 5, access to credit for working capital and for growth capital related to the export initiative is critical for firms to start exporting and to sustain their export initiatives.
- **Workforce:** Worldwide, SMEs that employ a skilled workforce are more likely to export more. The skills gap in LAC may be particularly pronounced in the several niche sectors requiring highly specialized training.
- **Planning:** Successful SME exporters tend to use a defined, systematic methodology to select plan export initiatives. They are more likely to have undertaken projects that required assessing risk in the face of potentially strong returns, and they routinely initiate market action and seek out a leadership position.
- **Product strategy and adaptation:** Optimizing the match between export market(s) and an SME's offering(s) is critical for success. In one study, export sales and export intensity were strongest among SMEs that designed their products with a view toward serving international rather than domestic markets. In another, 22 percent of SMEs that developed new offerings independently did so as a consequence of foreign market activity.
- **Relationship development:** For SMEs in particular, relationship management is another core driver of export success. A meta-analysis of 33 export studies in multiple countries and sectors revealed the centrality of closely managed, high trust, long-term relationships with distributors and large buyers. Along with stable sales, they provide market knowledge that is otherwise hard to acquire, and can spur higher levels of accountability. Yet the pattern of rapid export entry and exit among LAC SMEs thwarts high-value relationship development.
- **Production and delivery:** Studies of foreign buyers indicate that meeting requirements on price, quality, volume, and schedule is of paramount importance. Production capacity is not the only barrier here; the SME must be able to reliably gather and understand requirements as its customers and channels define them, and it must be able to regularly organize processes and product innovation.
- **Technology and innovation:** A body of work substantiates a causal relationship between SME technology capabilities and export entry, and in some cases export intensity, growth, and/or share. The experience of

numerous top-performing SME exporters during the East Asian miracle makes clear that technology formation among emerging market SMEs is heavily dependent on tacit (nontransferable) skills and knowledge, which enables the firm to absorb and particularize existing technology or combinations of technology.

We ended with a look at the growing phenomenon of born-global companies, also known as micro multinationals. Born-global firms are young SMEs that achieve high export intensity early in their histories, often very soon out of the gate. Many have been remarkably successful on the global stage, and their experiences hold particular promise for growth via exporting in high value-added sectors such as technology, and for countries with small domestic economies. Further, born-global firms' use of enabling communications technologies and their approach to sharing risks and rewards with strategic partners, along with their speed, and flexibility and dedication to superior offerings, hold lessons for traditional globalizing SMEs as well.

This analysis strongly suggests that LAC stakeholders supporting SME internationalization could score significant gains from a new approach to screening, training, and developing the assets and (especially) the often hard-to-build capabilities of regional SMEs incorporating the factors detailed in this chapter.

Measures and targeted remedies might include the following:

- Assist SMEs in overcoming the coordination barriers and asymmetries of information that impede both the development of sophisticated capabilities as well as the identification and recruiting of the high-caliber human capital necessary for their design and execution. Support for export committees, clusters, and other collaborative arrangements can help improve SME odds of positively navigating the organizational complexities of exporting. SME export consortia in Argentina have played such roles as encouraging the sharing of lessons across participating firms.<sup>68</sup> Measures that pool resources among firms have also been useful in attracting seasoned management and in developing stable, trusted relationships with export customers, partners, and distributors.
- It appears from this research that beginning SME exporters may perform best in overseas markets characterized by relatively less product, process and channel, such as markets that are either physically or



psychically closer to home. These markets can allow SME exporters to build their resources and learn by doing, such that some may expand into more distant and challenging markets later. In working with SME clients, regional EPAs can help guide SMEs accordingly. In a related vein, in Chapter 8, we explore the opportunity to target a portion of the region's export promotion resources specifically to focus LAC SME export initiatives on the many culturally proximate segments within the large and fast-growing US Hispanic Diaspora.

- Increasing the percentage of born-global firms in the region holds significant potential for high value-added, knowledge-driven and/or high-service industries, and for the region's smaller economies. Expanding born-global firms requires unique solutions to overcome the market failures impeding SME access to credit and management talent. In fact, when compared to the typical SME exporter, born-global firms have even higher needs for capital and management sophistication: the talent to manage their complexity is scarce, while their operations can be costly. Yet their limited track records exacerbate the gap between need and access. Well-designed financial and networking interventions can help bridge the market failure. An example is Malta Enterprises' grants and loan guarantees for early-stage technology start-ups with high international potential, as detailed in Chapter 6.
- Innovation policy can help overcome the general problem of underinvestment in technology and innovation that stems from the free-rider principle, and that is particularly acute among SMEs. Research on intra-firm determinants of SME export performance indicates that interventions related to innovation have an enormous contribution to make to SME export growth. However, to maximize linkages with SME exporting, it appears that such solutions should be designed to incentivize and support a very specific type of technology formation process. This process is not primarily about patents or codifiable knowledge; rather, it concerns technology acquisition, technology absorption and iterative innovation, and it is embodied in an SME's cross-functional skills and organizational structures.
- To date, many SME export training and coaching programs cover customs, documentation, transportation, logistics, and compliance issues that are unique to export markets. Exporting is a field of details, and it is likely that current programs have responded accordingly. While EPAs often assess potential client firms before assistance begins, the

lessons presented in this chapter make it abundantly clear that potentially greater gains would be generated by screening and training SMEs against the requisite assets and capabilities delineated here. In short, this material provides a new strategic lens through which to view a given firm's strengths and weaknesses, as these will impact its ability to grow through exporting.

- Wide-scale improvement in the intra-firm determinants of SME exporting requires strong communication and integrated design across programs and government agencies that address a suite of related challenges and market failures. This full chain of support may include capital development programs, management coaching, training on the absorption and iteration of technology, as well as capacity building and knowledge building on export success drivers. Moreover, it requires a sharing of lessons across these diverse practitioners and perspectives, and collaboration with the private sector.

Our results also point to gaps in our grasp of intra-firm determinants to export growth. A key step to bridge this gap is to generate and construct fresh data specific to regional SMEs. Overall, data are lacking; where data exist, access is lacking. There is a strong need for research that prioritizes issues by sector and stage of internationalization; integrates approaches from both the international trade and management science literature; and teases apart sector from cross-sector dynamics. This chapter has sought to point the way. Additionally, there could be significant benefit in investigating how the requisite assets and capabilities have been acquired and developed by top performing SME exporters, and where shared resources or support systems have played a part.

In closing, it cannot be overemphasized that the specific capabilities at the heart of successful internationalization are inherently learning based. They involve ongoing and iterative processes based on real world trial and feedback; they are largely incremental; and they require a continual, long-term management commitment. This has an important implication for assuring the effectiveness and for maximizing the impact of possible training and capacity-building initiatives, discussed above as policy options to address the market failures of information asymmetries, inadequate access to technology, and innovation absorption capacity, and so on.

Our findings strongly suggest that the requisite drivers should be reassessed at multiple points in a firm's export trajectory if SMEs are to maintain

and gain momentum in foreign markets. This implies a new approach to capacity building—a firm-centric approach that empowers individual SMEs to determine and shape their priority investments for export stability and growth at any given point. Unlike one-time training, this kind of capacity building would provide management with access to a full range of essential assessments, decision-making tools, learning, and improvement activities. It is our belief that such a paradigm shift will also help to produce a cadre of regional exporters that are better equipped to commit, survive, and grow into multiproduct, multimarket exporters.

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- 33 Eaton et al. (2007). Export Dynamics in Colombia: Firm-Level Evidence. Borradores de Economía 003957, Banco De la Republica.
- 34 Sabel, C. et al., eds. (April 2012). *Export Pioneers in Latin America*. IDB.
- 35 Leonidou, L. C. (2004). An analysis of the barriers hindering small business export development. *Journal of Small Business Management*, 42(3):279–302.

- 36 The current literature on trade generally assumes that SMEs compete in one of two ways when entering export markets: through a low-cost position that uses aggressive pricing to attain a high sales volume, or through product differentiation premised on distinctive, unique, and/or customized benefits that fill market gaps. In the low-cost strategy, the structural barrier allowing the firm to protect its territory, once won, requires ongoing production improvements to continually stake out cost excellence. Structural competitive advantage in the differentiated strategy is based on a reduced likelihood of customer switching and substitution, and thus requires ongoing marketing expenditures to promote the branded differentiation.

However, it is our view that this work simplifies strategic management theory to a degree that may be limited in value. A number of business theories offer additional ways of viewing competitive (structural) advantage. For example, George Day introduced a three-pronged framework through which to analyze product positioning: low-cost (for example, Walmart); customization (for example, Dell); and continual innovation (for example, Nike). Michael Porter evolved his thinking to emphasize the firm as a system of interrelated capabilities, all of which must be focused on and capable of delivering a highly specific value proposition. Meanwhile the McKinsey Global Institute recently wrote that in most fast-changing emerging markets, customers are extremely price conscious and demanding in terms of the feature set. We have not seen these, or other current theories, that influence the research on SME internationalization.

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- 38 Gudlavaletti, Gupta, and Narayanan op. cit.; Astmon et al. (August 2012). Winning the \$30 Trillion Decathlon: Going for Gold in Emerging Markets. McKinsey Quarterly; Diaz, Magni and Poh (October 2012). From Oxcart to Wal-Mart: Four Keys to Reaching Emerging-Market Consumers. McKinsey Quarterly.
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- 45 Wheeler, Ibeh, and Dimitratos op. cit. also citing Bell, 1995; Coviello and Munro, 1997; Crick and Jones, 2000; Hellman, 1996.
- 46 Fernández, Z., and M.J. Nieto (2005). Internationalization Strategy of Small and Medium-Sized Family Businesses: Some Influential Factors. *Family Business Review*, 18(1):77–89.

- 47 Cavusgil, S. T., and S. Zou (1994). Marketing strategy-performance relationship: an investigation of the empirical link in export market ventures. *The Journal of Marketing*: 1–21.
- 48 Day op. cit.
- 49 Nazar and Saleem op. cit. citing Shamsuddoha and Ali 2006; Cavusgil and Zou 1994; Leonidou et al.
- 50 Louter, P. J., C. Ouwerkerk, and B.A. Bakker (1991). An inquiry into successful exporting. *European Journal of Marketing*, 25(6):7–23.
- 51 In our view, the majority of studies on influencing export relationships through marketing levers fall short on many dimensions, of which several follow:

First, these findings do not adequately account for the marketing activities of channel partners, solutions providers, wholesalers and/or retailers which may or may not be part of the chain that links LAC SME seller and the foreign end customer. Second, it is likely that many smaller emerging market SMEs target pillar customers, rather than a less concentrated market base in which the preferences and profiles of individual buyers are known only in the aggregate; this would imply a very different need for and dynamics of advertising, sales promotions, and other components of the marketing mix.

Third, there are many issues involved in the effectiveness of marketing which cannot be conflated in analysis, including the importance of qualitative parameters such as persuasiveness and creativity, and the great differences required in expenditure depending on customer and competitor structure in a specific target market.

Fourth, some studies have treated potentially strategic variables as tactical issues, e.g., the selection of price points, which in the case of a differentiated product strategy is an important means for communicating market position relative to competitive alternatives and thus shaping customer expectations. It is noteworthy that internationalization studies have not found an independent effect of pricing on export success. We believe that this is because in many situations, price points are a means of communicating with customers. For example, differentiated or customized products often utilize premium pricing to communicate and support claims of distinctiveness. Because pricing is relative to that of competitive offerings, which may exist in tiers or categories relevant to specific customers, and which may employ a variety of pricing models, the issue is likely more nuanced than existing studies have indicated.

Fifth, these marketing-focused studies also tend to omit the influence of and interplay with activities in other firm functions that are of strategic significance depending on sector (flexible manufacturing, just-in-time purchasing, etc.) On this point, we acknowledge the insight of Katsikeas, C. S., L.C. Leonidou, and N.A. Morgan (2000). Firm-level export performance assessment: review, evaluation, and development. *Journal of the Academy of Marketing Science*, 28(4): 493–511.

Sixth, and critically, this body of work finds a very large number of marketing variables important without clearly prioritizing a few.

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- 53 Gunaratne, K. (2009). Barriers to internationalization of SMEs in a developing country. ANZMAC.
- 54 Söderbom, M. (2000, June). What drives manufacturing exports in Africa? Evidence from Ghana, Kenya and Zimbabwe. In *A paper prepared for Annual Bank Conference on Development Economics Europe* (pp. 26–28), citing Hoogeveen and Mumvuma (1999).
- 55 Where the evidence is less conclusive, several issues seem to come into play, among them: how to measure technological capability; differences between product and process innovation; an inability to differentiate between categories of exporter by length of survival in the export market; the effects of sector, type of offering and/or firm size.
- 56 Nguyen et al. (2008). Innovation and exports in Vietnam's SME sector. *The European Journal of Development Research*, vol. 20, issue 2.
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- 59 Cassiman, B. and E. Martinez-Ros (2007). Product Innovation and Exports: Evidence from Spanish Manufacturing. IESE working paper, mimeo.
- 60 Chantanaphant, Nabi, and Dornberger (2010). Impact of Technological Capability on the Export Performance of SMEs in Thailand. [www.aalto.fi](http://www.aalto.fi) Accessed September 8, 2013.
- 61 Crespi, G. and P. Zuniga, (October 2010). “Innovation and Productivity: Evidence from Six Latin American Countries.” IDB Working Paper Series no. IDB-WP-218.
- 62 This articulation of the problem is drawn from Wignaraja op. cit. page 2.
- 63 Tsai, K. H. (2004). The impact of technological capability on firm performance in Taiwan's electronics industry. *The Journal of High Technology Management Research*, 15(2): 183–195.
- 64 Figueiredo, P. N. 2001. *Technological learning and competitive performance*. Edward Elgar Publishing; Lefebvre, E., Lefebvre, L. A., and Bourgault, M. (1998). R&D-related capabilities as determinants of export performance. *Small Business Economics*, 10(4):365–377.
- 65 Ernst, Ganiatsos, and Mytelk, eds. *Technological Capabilities and Export Success in Asia*. Routledge Studies in the Growth Economies of Asia. (Year?)
- 66 Von Hippel's influential research documented that in a wide range of industries, many innovations are developed by users and later adopted by manufacturers: Von Hippel, E. (2007). *The sources of innovation* (pp. 111–120). Gabler.
- 67 Lehmann, R.; Schlange, L. (2004): Born Global. *Zeitschrift für KMU und Entrepreneurship*, vol. 52, no. 3.
- 68 Bekerman, Wiñazky, and Moncaut (October 2013). “Políticas productivas para fortalecer la inserción internacional de las empresas PyMEs. Los consorcios de exportación en Argentina.”



**S**MEs need capital to grow and export. Financing enables SMEs to set up and expand their export-related operations, offer competitive payment terms to foreign customers, develop new export products and markets, and invest in production facilities and new capabilities and staff required for exporting.

At the same time, SMEs face high hurdles to access capital. Given their higher volatility and limited financial track record, SMEs are typically more credit constrained than are large firms, and they must struggle to access affordable credit and adequate financing. Fewer external financing sources are available to them and they typically rely much more on banks than do larger firms, which can raise capital through issuance of bonds, commercial paper, or publicly traded equity.

SMEs are subject to further financial constraints due to the high sunk costs and uncertainties involved in export operations. Added to this are the long payment terms increasingly demanded by large global buyers such as MNCs, which translate into cash flow problems for the SME. And despite their exceptional potential for innovation and growth, prospective “born-global” companies are particularly disadvantaged, as they have limited collateralizable assets. Finally, equity financing is often available only for a select number of firms.

This mix of factors creates market failure, a “financing gap” that holds back SMEs’ growth and export potential, and widens disparities between large and small exporters. These challenges are particularly serious in developing regions such as Latin America, which has less sophisticated financial systems than advanced economies.

The purpose of this chapter is to review the literature on the availability of credit to SMEs and the impact of capital on SMEs’ export prospects, and present fresh data on the severity of the financing gaps facing LAC SMEs. The first section discusses the relationship between firm size and exporting on the one hand, and firm’s access to capital, on the other. Section two assesses the depth of the financing gap facing LAC SMEs, drawing comparisons with large firms and other world regions. The third section concludes with key findings.

## I. Access to Capital: Importance of Size and Exporting

SMEs generally have more limited access to capital than large companies. In a survey of 10,000 firms in 80 advanced and developing countries, the probability that a small firm lists financing as a major obstacle is 39 percent, compared to 36 percent for medium-sized firms and 32 percent for large firms.<sup>1</sup> There are five principal reasons why SMEs struggle to access credit:

- **Higher volatility and risk.** SMEs tend to have greater volatility in earnings and growth than do larger companies. With more limited revenues, SMEs also have less cushion than do large firms, and thus their survival rate is typically lower than that of larger companies. In fact, SMEs are up to five times more likely to fail than large firms. As such, SMEs are seen as riskier investments than large companies, causing lenders to demand higher interest rates or refuse to offer credit altogether.
- **Fixed transaction costs.** An axiom of finance is that fixed transaction costs in credit assessment, processing, and monitoring decrease as the size of the loan increases. It typically takes as much work to assess the credit worthiness of a small borrower as a large one. The high fixed costs in small business lending entail a proportionally higher interest rate for small borrowers.
- **Adverse selection.** SMEs often get trapped in the problem of adverse selection. As the interest rate charged to a firm rises, banks know that borrowers undertake riskier projects to compensate for the higher cost of capital. However, by doing so they also have a higher probability of default. The higher default probability decreases the expected return to the lender, which discourages lending.
- **Asymmetric information.** Lenders regard financial information and the ability to enforce collateral as critical for fluid financial services to SMEs. However, SMEs are often more opaque than large firms, as they have less financial history and formal financial tracking processes. It is also difficult for creditors or investors to distinguish the SME's financial situation from that of its owners. These challenges are particularly difficult in developing regions due to more limited financial information and creditor ability to assess it.<sup>2</sup>
- **Limited banking relationships.** Information asymmetries increase loan assessment and monitoring costs and place an onus on the quality of the relationship between the borrower and the lender. However,

with limited staff and time, SMEs have high opportunity costs to cultivate relationships with lenders, or to diversify these relationships so as to shop around for the best deal and relationship.<sup>3</sup>

Granted, SMEs that face bank credit constraints can seek alternative financing sources. One such source is equity financing. However, particularly in emerging markets equity investment is available only for select firms, and many SME owners are reluctant to give up ownership of their companies. SMEs that supply large buyers may be able to access supply chain finance (SCF), but SCF is still underutilized, especially in emerging markets. Still another way in which an SME can finance their growth and business operations is by supplier credit, or credit provided by the SME's suppliers of raw materials and inputs. There is evidence that firms in industries with greater reliance on supplier credit grow faster in countries with low levels of financial development.<sup>4</sup> However, supplier credit does not appear to offset declines in bank credit, and may also be less available in countries with lower levels of financial development, as is the case of Latin America.<sup>5</sup>

In light of these challenges, LAC SMEs risk falling into the “missing middle” in capital markets. Banks tend to shy away from smaller deals with high transaction costs, yet alternative lenders focus on very small opportunities. A loan of \$300,000 would typically be too small for a bank, yet too large for a microfinance institution. Stuck in the missing middle, SMEs have few possibilities but to turn to their own resources.

Financing constraints can be enormously detrimental to firm growth. When asked to name the most severe obstacles to growth in a recent survey, SMEs around the world listed lack of financing as the second most severe obstacle (after corruption), while large firms ranked it fourth.<sup>6</sup> The impact of the financing gap on growth is even greater in countries with less developed financial and legal systems.<sup>7</sup>

### **A. Why Aspiring Exporters Often Lack Access to Credit**

SMEs that export or aspire to export face an additional set of financial issues. On the one hand, since exporters typically outperform non-exporters, they should be expected to have an easier time accessing capital. Yet export-related investments can be harder to secure, for three reasons:

- **Exporting involves high sunk costs.** Export activity generates additional financial needs for which exporting firms need to identify

capital. Export entry involves high up-front sunk costs stemming from such activities as identifying foreign customers and new export markets, creating distributor networks, and meeting foreign product standards. These costs are proportionally much greater for SMEs than they are for large firms. These costs are not negligible. For example, the average entry cost for small Colombian exporter entrants is estimated at \$412,000-\$430,000 in three industries (leather, knitting, and chemicals).<sup>8</sup> These costs are clearly easier for large rather than small firms to meet. What is more, large entrants had in fact lower entry costs (\$344,000-\$402,000), possibly due to more extensive preexisting contacts and distributor relationships.

- **Export operations have higher variable costs.** Export transaction costs such as shipping, logistics, and trade compliance costs, can be more onerous than costs incurred in the domestic market. For example, cross-border shipping and delivery usually take 30–90 days longer to complete than do domestic orders, with each day in transit adding to shipping costs.<sup>9</sup> In addition, exporters need sufficient resources to manage risks such as potential customer nonpayment, exchange rate instability, and cash flow problems.
- **Exporting is more uncertain.** Cost of capital rises with risk. Investments related to internationalization can be viewed as riskier and more tentative in terms of their return profile. Included are investments related to market development, creation of a distribution network, and new product development for a certain export market.

While there are no recent surveys on the importance of access to capital among exporter SMEs in LAC, surveys in advanced markets highlight the hurdles that lack of capital imposes on export activities. In a 2008 OECD survey, 230 SMEs ranked working capital as the most serious of 47 hurdles to trade.<sup>10</sup> In a 2010 survey commissioned by the European Commission of nearly 9,500 European SMEs, 54 percent of SMEs viewed lack of capital as an important barrier to doing business in the EU market, and 44 percent to doing business in extra-EU markets. No other barrier (paperwork, laws and regulations, lack of information on overseas markets, etc.) was considered as important. Similarly, in a 2010 US International Trade Commission study, US manufacturers rated access to financing as the steepest out of 19 hurdles to trade.<sup>11</sup>

These views are not surprising: Access to capital plays a critical a role in firms' export outcomes in at least four ways:

- Access to capital makes or breaks export operations. Firms that are unable to overcome the credit constraint are less likely to internationalize.<sup>12</sup> The less financially constrained firms are more likely to start exporting earlier than other firms.
- Since SMEs struggle to raise external funds, they cover sunk costs involved in export entry by relying on internal liquidity, when that is available. A study of Italian firms finds that export entry decisions by credit constrained firms are determined by their level of cash stock.<sup>13</sup>
- Export entrants that are able to access credit tend to have higher leverage than do comparable non-exporters. This suggests that foreign market entry costs are significant and meeting them forces firms to draw down liquidity or increase leverage.<sup>14</sup> This may ultimately not benefit the SME because it may need to charge higher prices to cover the borrowing costs.
- Large international buyers increasingly want better terms from their SME suppliers, such as a longer payment cycle. Yet the supplier SME needs continuous free cash flow to purchase new supplies to produce new orders and cover business expenses. Typically, the SMEs make up for the gap in cash flow by borrowing against their accounts receivable. However, the terms involved in this arrangement can be very taxing on the supplier's financial viability, which in turn poses a supplier risk to the buyer.

Financial constraints can impede firms from exporting altogether. Even if they overcome the sunk entry costs, they often must resort to sporadic, ad hoc exporting due to cash flow problems and elevated variable costs.

The financing challenges can be particularly acute for exporters in sectors that are more dependent on external finance, such as transportation equipment and other durable goods. The same is true for exporters with few collateralizable assets; this would be the case with information technology or professional services firms.<sup>15</sup> Firms in sectors highly dependent on external finance are also more sensitive to financial crises when trade finance dries up and debt servicing costs surge, which can force them to exit from export markets.<sup>16</sup> Crises in general are detrimental to existing exporters. A study of Peruvian firms during the 2008–09 financial crisis finds that a 10 percent decline in credit reduced the intensive margin of exports by 2.3 percent, and the number of firms that supply a product-destination by 3.6 percent; yet the drop in credit had no impact on entrants.<sup>17</sup> Overall, credit shortages

explained 15 percent of the decline in Peruvian exports during the crisis. SME exports are also found to be particularly sensitive to the termination of credit enhancements.<sup>18</sup> A study of French exporters during the crisis shows a similar deterioration along the intensive margin.<sup>19</sup>

A recent study of Colombian exporters finds that a 10 percent increase in access to finance (short- and long-term debt and other debt instruments) increases a small firm's exports by 1.2 percent and a midsize firm's exports by 0.7 percent. In addition, access to credit enables firms to increase their product mix.

Access to capital fuels exporting, but does successful exporting fuel access to capital?

According to studies on the relationship between exporting and access to finance, exporters typically have more liquidity and less credit restraints than non-exporters.<sup>20</sup> Given that exporters are high-performing firms with strong productivity, they could be expected to be less credit constrained. There are indeed a number of reasons to believe that sustained exporting fuels access to credit, which include the following:

- Exporting may boost productivity, and more productive firms are less credit constrained.
- The act of exporting may send a positive signal to capital markets. It reveals that the firm is productive enough to generate profits in foreign markets that will recover the sunk costs involved in exporting. As such, the firm is also seen as able to service its debt, which relaxes the credit constraint.<sup>21</sup>
- Internationally active firms can have better contacts and access to foreign capital markets, and a larger number of financial windows, than do domestic firms.
- Especially important, exports can play a countercyclical role. Diversified exporters in particular are less beholden to domestic business cycles than are non-exporters or narrow exporters. They are also better able to withstand negative shocks in any one foreign market or product line. Exporters' cash flows are also found to be more stable than those of non-exporters.

For example, a study of UK firms finds that exporters with a decade of exporting are significantly healthier financially than non-exporters or exporter entrants (which struggle with the high leverage to cover sunk costs).<sup>22</sup>

### **B. Summary: Exporting and Access to Credit**

In sum, these findings point to three key considerations for LAC SME exports:

- LAC SMEs that are seeking to export can be seen as triply credit constrained: they are small, they are seeking to engage in a putatively risky activity with high sunk costs and uncertain returns, and they are interfacing with a financial system that is less sophisticated than that available to firms in advanced nations.
- Exporting involves serious costs that can hamper LAC SMEs' export entry and diversification, since SMEs must struggle to access capital. SMEs with internal resources and/or access to external credit are better positioned to pursue export opportunities.
- There is a two-way relationship between exporting and access to credit. Export success entails success in capital markets. Particularly seasoned and diversified exporters have steadier cash flows and fewer credit constraints than non-exporters. Meanwhile, access to credit particularly fuels SME exports, boosting both export volumes and product mix.

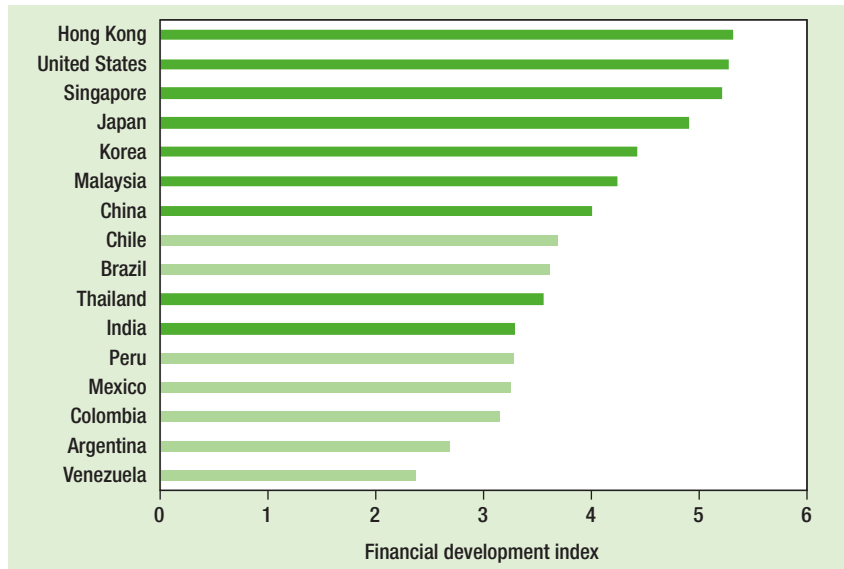
How credit constrained, then, are LAC SMEs? The next section provides answers.

## **II. LAC SMEs' Access to Finance**

At first blush, LAC SMEs face a difficult financing environment. Most LAC countries trail advanced economies and Asian nations in their financial development. They rank in the lowest quartile of the World Economic forum's 62-country index of financial development, which is defined as "the factors, policies, and institutions that lead to effective financial intermediation and markets, as well as deep and broad access to capital and financial services" (Figure 1). While the results of the index are important for firms in general, the relationship between a LAC country's financial development and firm growth is particularly critical in the case of SMEs. For example, in comparison to large firms in the same industry, small firms in countries at higher levels of financial development are more likely to spend on R&D.<sup>23</sup>

However, understanding the credit environment facing LAC SMEs further benefits from an assessment of firm-level data. Granted, the data reviewed in this section do not allow for a rigorous analysis of LAC SME

**FIGURE 1 /**  
**Financial Development**  
**Index and Ranking out**  
**of 62 Countries in 2012,**  
**Select Countries (LAC**  
**Economies in Blue)**



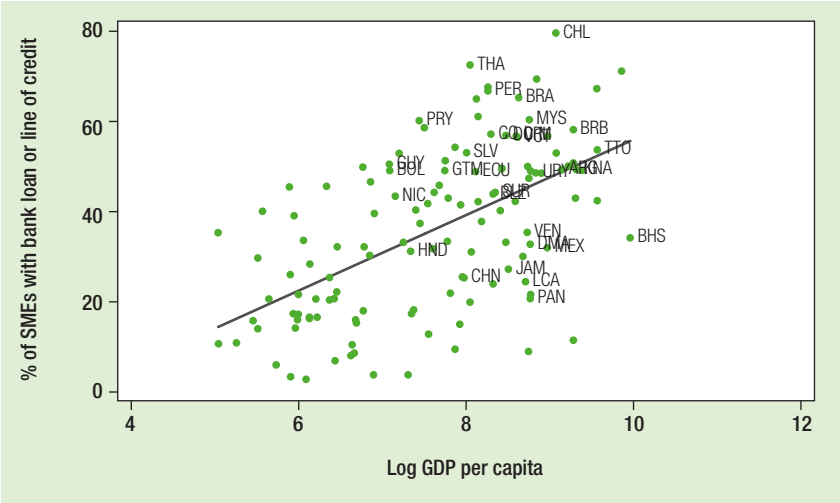
Source: World Economic Forum (2012).

exporters per se, because each firm's export status—duration of exporting, diversity of export markets, and success at exporting—is not available. The overall data indicate that SMEs that earn more than 10 percent of their sales from exports do slightly better at accessing capital, although conclusive evidence is not available. As such, we will focus on access to financing among LAC SMEs, whether non-exporters, export aspirants, recent entrants, or longtime export incumbents.

The analysis of LAC SMEs' access reveals several patterns. The first is that LAC SMEs are quite integrated in the banking systems despite their lack of access to financing. Ninety-three percent of LAC SMEs have bank accounts, and 48 percent have access to loans or a line of credit. In contrast, only 39 percent of East Asian SMEs have access to loans, 22 percent in Sub-Saharan Africa (Figure 2). According to an IDB survey, the level of loan approvals for LAC SMEs is also relatively high, at 80 percent in such countries as Brazil and Argentina.<sup>24</sup>

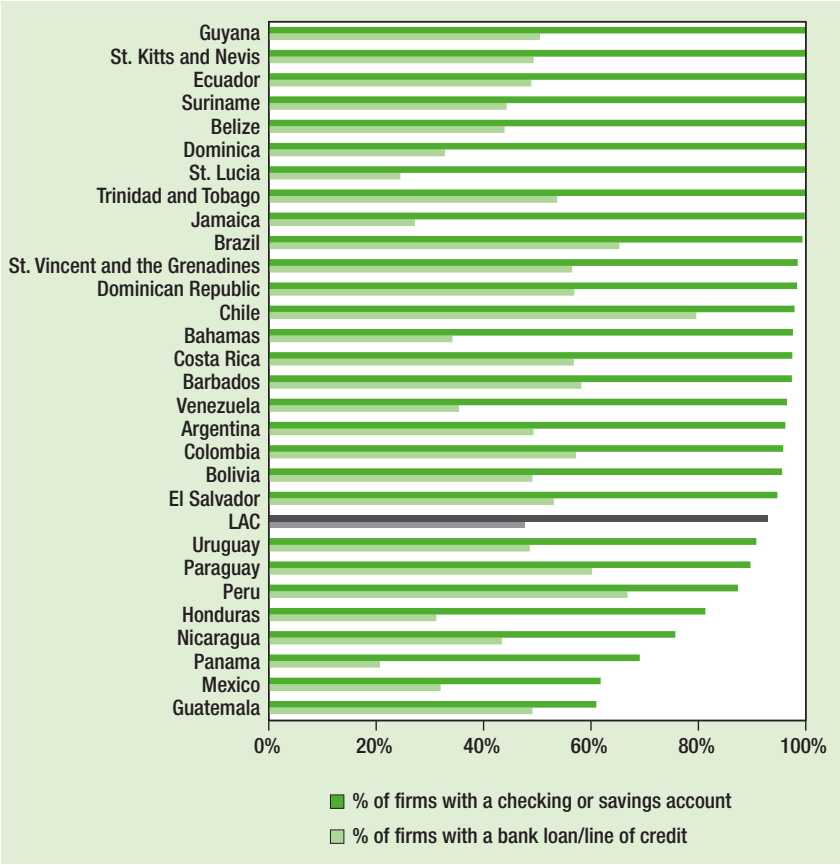
To be sure, there are large differences among LAC nations in access to credit. For example, while almost all SMEs in Brazil have a bank account and three-quarters have loans or lines of credit, only 62 percent of Mexican SMEs have a bank account and only a third have access to a loan (Figure 3). Fewer LAC SME loans (72 percent) require collateral for a loan than loans issued to SMEs in other developing regions.





**FIGURE 2/**  
Percent of SMEs with a Checking or Savings Account and Percent of Firms with a Bank Loan/Line of Credit, by Country

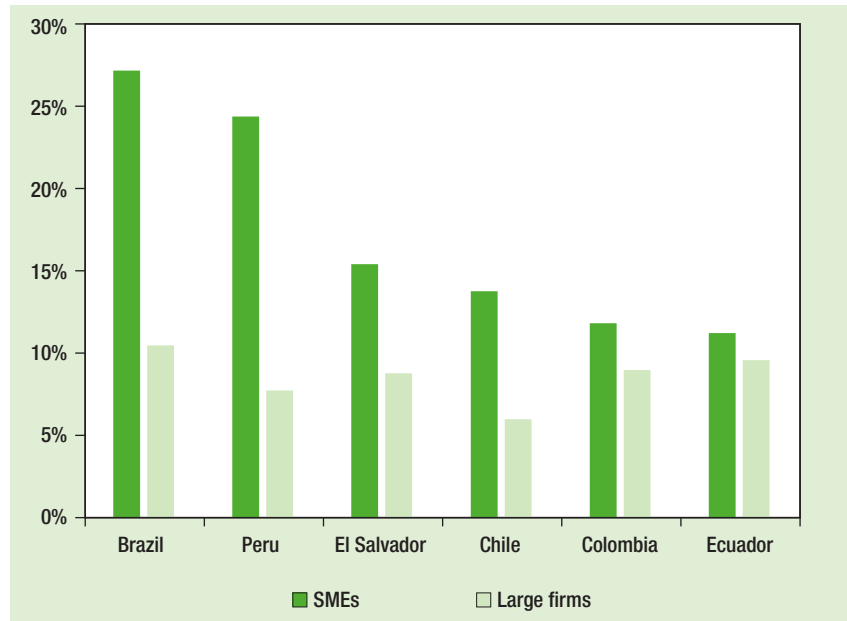
Source: Enterprise Surveys.



**FIGURE 3/**  
Percent of SMEs with a Checking or Savings Account and Bank Loan/Line of Credit, by LAC Country

Source: Enterprise Surveys.

**FIGURE 4/**  
**Interest Rates for SMEs**  
**and Large Firms in**  
**Select LAC Countries:**  
**Long-Term Loans**  
**(maturity greater than**  
**one year), monthly**  
**averages of first half of**  
**2012**



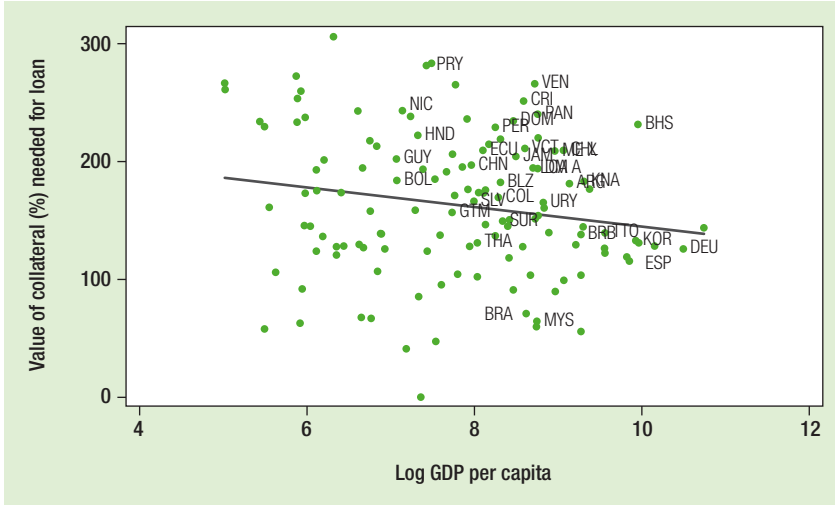
Source: OECD Development Centre, based on national data (2012).

### A. Limited Access to Credit

However, these data disguise challenges LAC SMEs face in accessing capital. There are marked differences between SMEs and large regional firms in actual access to capital. This helps explain LAC SMEs' low export participation rates and limited export diversification. When compared to large LAC firms, LAC SMEs pay significantly higher interest rates, particularly in Brazil and Peru, where interest on SME loans is 25 percent or more (Figure 4). LAC also has some of the world's highest net interest margins, i.e., the accounting value (or carrying value) of net interest revenue as a share of total earning assets. The regional average of 8.6 percent is triple that of the OECD area. The high net interest margin translates into fewer profitable investment projects for LAC firms, especially SMEs. The likely explanation for the high net margins is banks' elevated overhead costs, which are still among the highest in the world.

Data on banks' collateral needs also suggest that capital comes at a cost for LAC SMEs. The amount of collateral needed to receive a loan in LAC is nearly 200 percent the loan's value, well above figures for comparable economies of the Asia Pacific region, and even above rates in many Sub-Saharan African countries (Figure 5).

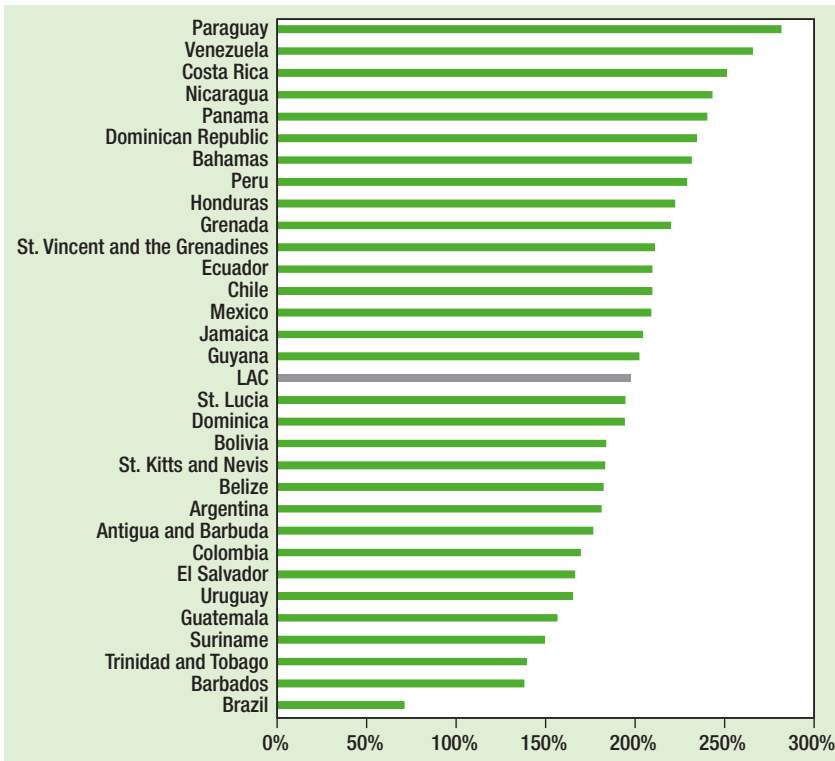
Collateral requirements are particularly high in Paraguay and Venezuela, exceeding 250 percent. They are also high in certain Central American



**FIGURE 5/**  
Value of Collateral Needed for a Loan in 2006–2010, by Region and Firm Size

Source: Enterprise Surveys.

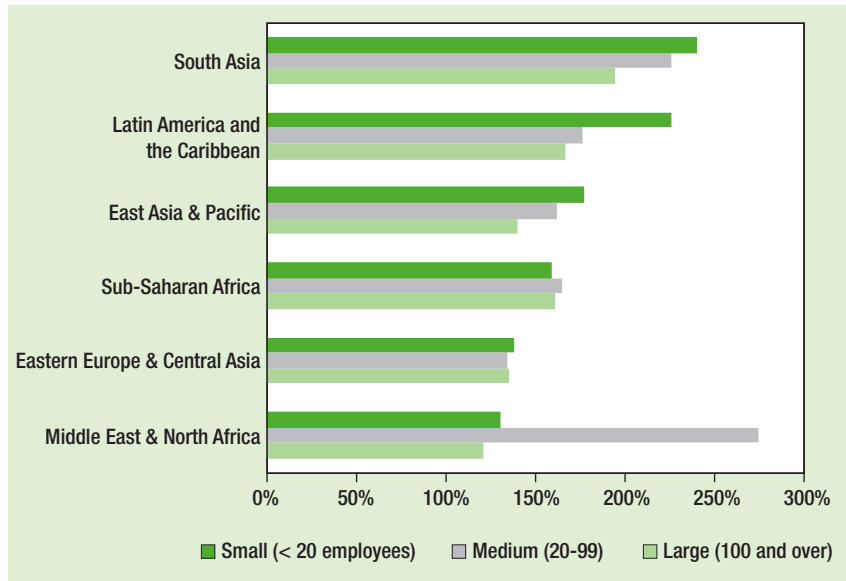
nations (Figure 6). Collateral for non-exporters and exporters is almost the same, at 195 percent and 197 percent, respectively. This could reflect the



**FIGURE 6/**  
Value of Collateral Needed for a Loan among LAC SMEs in 2010, by Country

Source: Enterprise Surveys.

**FIGURE 7**  
**Value of Collateral**  
**Needed for a Loan in**  
**2006–2010, by Region**  
**and Firm Size**



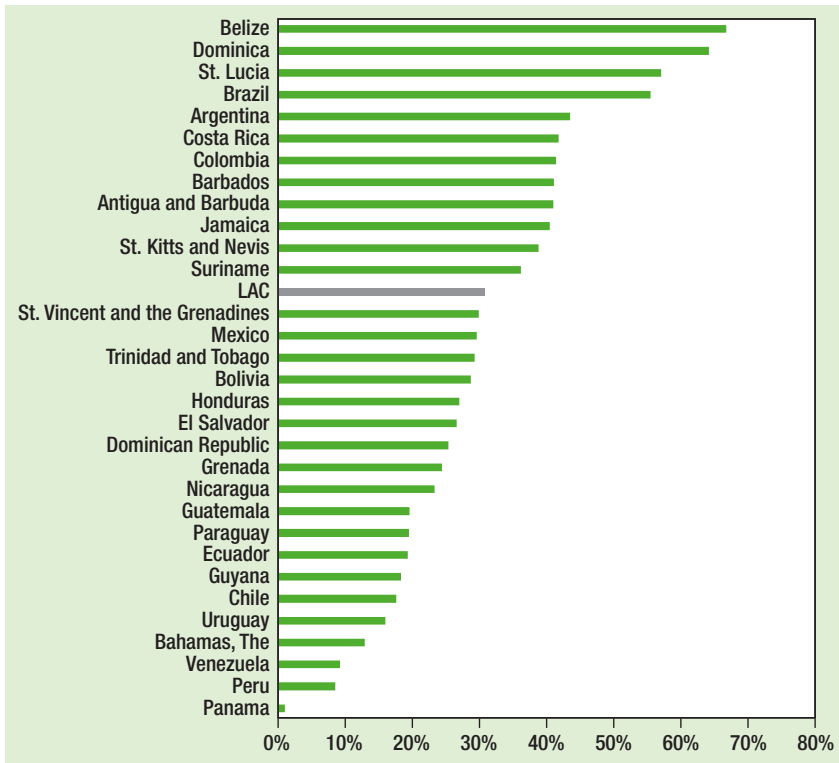
Source: Enterprise Surveys.

fact that while exporters outperform, they may also engage in riskier investments. Firm size and required collateral appear to be inversely related: SMEs with 20 or fewer employees can be required to provide over 220 percent of collateral on the loan value, as opposed to about 170 percent for midsize SMEs and 150 percent for larger SMEs (Figure 7). These levels are among the highest in the world.

Given these patterns it is perhaps not surprising that 31 percent of LAC SMEs regard obtaining credit as a major constraint (Figure 8). SMEs' perceptions of access to credit vary widely in the region, with more than half of Brazilian SMEs identifying lack of access to capital as a major constraint, while only a fifth of Chilean SMEs shared that view. SMEs in the Caribbean nations also find it hard to access capital. Small and medium-sized LAC SMEs (those with 20 or fewer, and 20–99 employees, respectively) report steeper hurdles to accessing capital than do larger SMEs (those with 100 or more employees). Nearly 32 percent of the smallest firms consider access to capital a major constraint, as opposed to 29 percent for medium-sized SMEs and 21 percent for large firms (Figure 9).

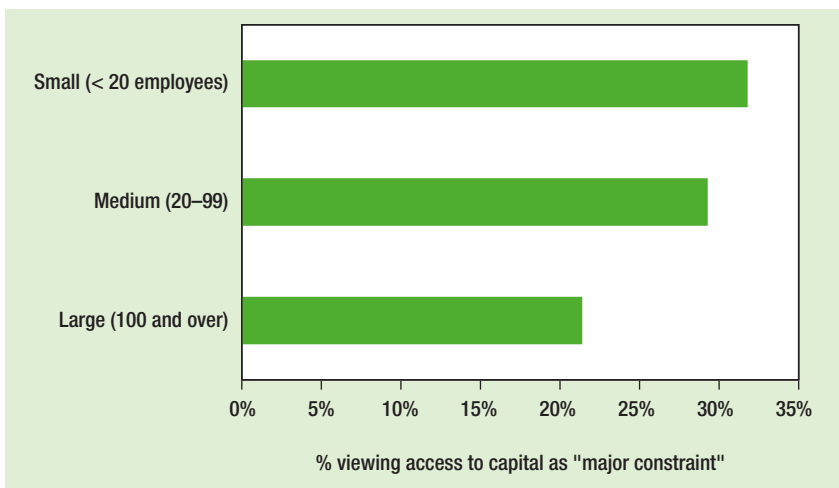
### **B. Do-It-Yourself Banking: Trends in Lending to LAC SMEs**

These trends also help explain why banks play a relatively limited role in LAC SMEs' daily operations. A third of LAC SMEs use banks to finance their



Source: Enterprise Surveys.

**FIGURE 8/**  
Percent of LAC SMEs  
Identifying Access  
to Capital as a Major  
Constraint in 2009–10,  
by Country



Source: Enterprise Surveys.

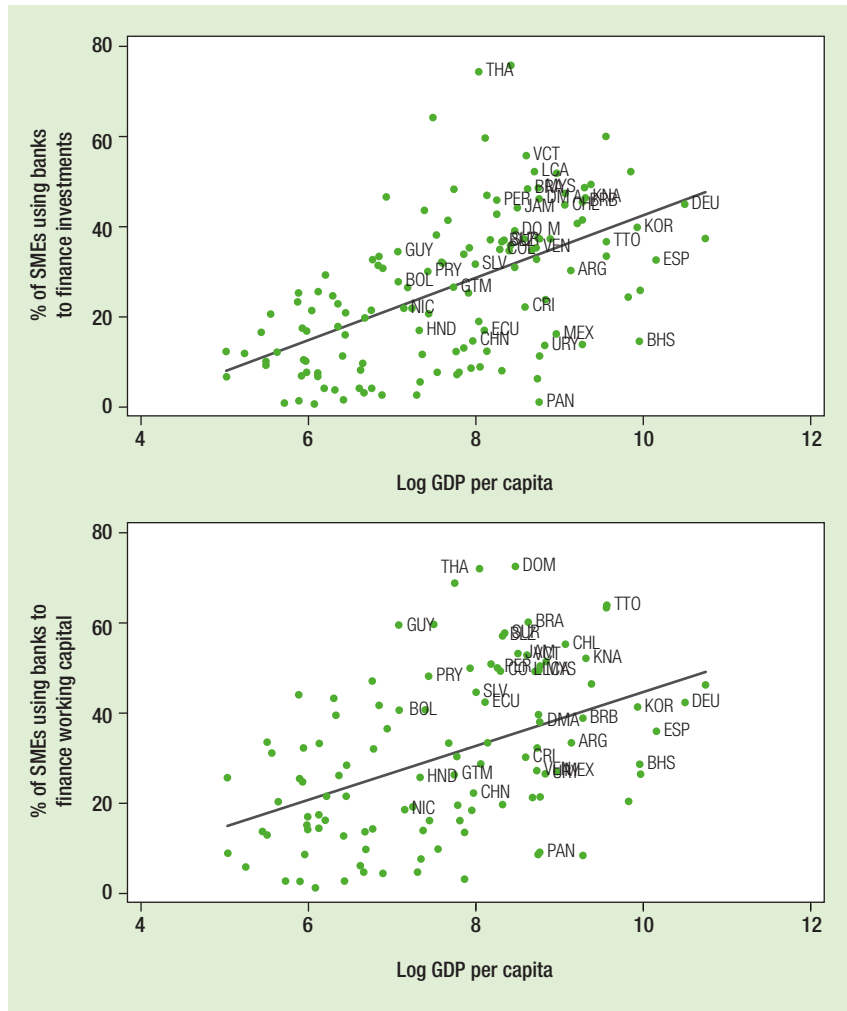
**FIGURE 9/**  
Percent of LAC SMEs  
Identifying Access  
to Capital as a Major  
Constraint in 2009–10,  
by Firm Size

investments and 43 percent use banks to finance working capital. Countries such as Costa Rica, Ecuador, and Mexico have bank use rates well below those of economies at similar levels of development (Figure 10).

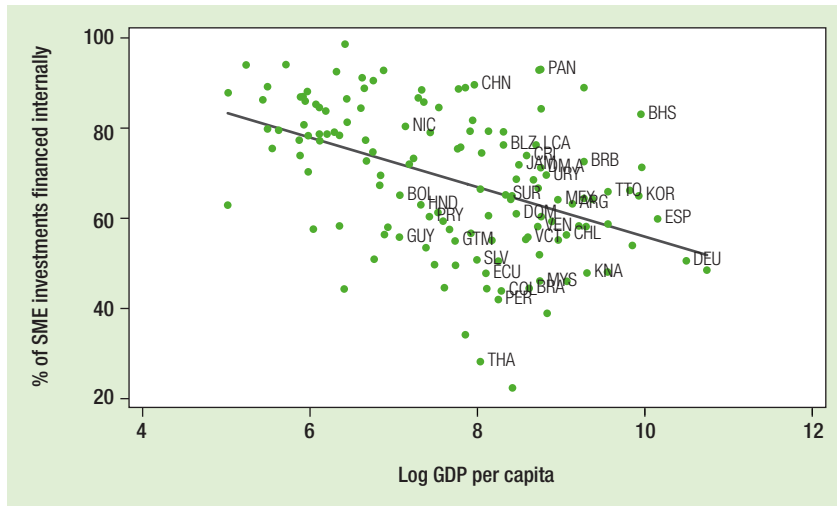
SMEs in LAC finance investments largely (64 percent) with internal resources (Figure 11). Bank financing makes up only 20 percent of LAC SME investments and only 16 percent of financing of their working capital needs. Supplier credit is also limited, making up 7.5 percent of LAC SMEs' investment resources.<sup>25</sup>

Granted, LAC SMEs use bank credit more in their investments than do SMEs in East Asia, where 72 percent of firms' investment financing is

**FIGURE 10/**  
**Percent of SMEs Using**  
**Banks to Finance**  
**Investments and**  
**Working Capital in**  
**2006–2010, by Country**



Source: Enterprise Surveys.



**FIGURE 11/**  
Percent of SME  
Investments Financed  
by Internal Resources  
in 2006–2010, by  
Country

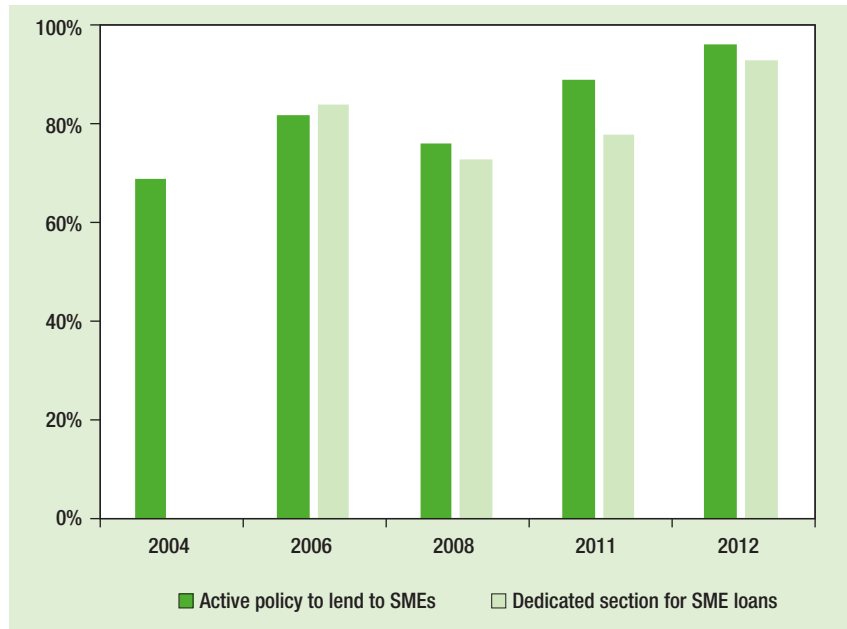
Source: Enterprise Surveys.

covered internally and only 15 percent comes from bank loans. For SMEs in the Middle East, only 2 percent of investment financing is covered by banks. In contrast, in the OECD nations, a third of investments are made with bank financing. Supplier credit covers 18 percent of LAC SMEs working capital needs.<sup>26</sup>

Over the past two decades, LAC banks have moved beyond the traditional relational banking to multi-service banking with more standardized screening processes and stronger risk assessment. The growing presence of foreign banks (currently about a third of the regional banking assets) has also played a positive role, as foreign banks tend to be more efficient than domestic banks and also have lower overhead and interest margins.<sup>27</sup> These shifts may augur well for SMEs. According to a recent IDB survey, LAC banks are increasingly focusing on the SME market given its perceived growth and the need of banks for portfolio diversification.<sup>28</sup>

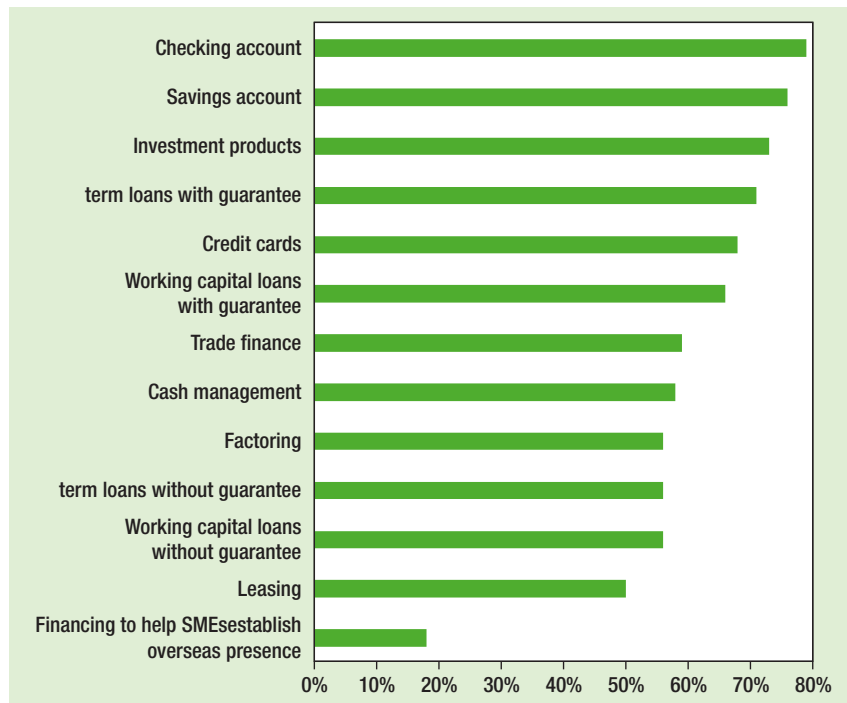
Most LAC banks also have a policy to lend to SMEs and a dedicated department or section for dealing with SME loans (Figure 12). All large banks, 87 percent of midsize banks, and 72 percent of small banks have a dedicated SME department, and 77 percent of banks in Latin America expect to increase investments in the SME segment.<sup>29</sup> The region's banks also offer a variety of instruments to SMEs (Figure 13). Most offer bank accounts to SMEs, and over 70 percent offer medium- and long-term loans that are guaranteed. Pertinent to internationalizing firms, 59 percent of LAC banks offer SMEs

**FIGURE 12/**  
Focus on SMEs among  
LAC Banks, 2004–2012



Source: IDB (2012), "Las Pymes de América Latina y el Caribe: un negocio estratégico para los bancos de la región, 5ta encuesta regional en América Latina y el Caribe."

**FIGURE 13/**  
Percent of LAC Banks  
Offering a Given  
Financial Product to  
SMEs in 2012



Source: IDB (2012), "Las Pymes de América Latina y el Caribe: un negocio estratégico para los bancos de la región, 5ta encuesta regional en América Latina y el Caribe."



trade finance products, and nearly a fifth also finance SMEs' overseas expansion. Factoring is offered by more than half of the region's banks.

Despite the gains, however, there is room for improving bank lending to LAC SMEs. Competition in the LAC banking sector is still inadequate, and many of the challenges of relationship banking persist. For example, credit assessment remains relatively weak, which perpetuates high fees and collateral requirements and inflexible financing terms. More than half of LAC banks report difficulties in assessing SMEs, especially in the region's informal sector. More than 40 percent of LAC banks still report high administrative costs for processing SME loans.<sup>30</sup> These costs are greatest for small banks. Going forward, the onset of Basel III capital requirements for banks can also increase the cost and reduce the availability of credit to SMEs. In turn, SMEs may self-exclude and not even seek financing due to steep search costs for capital and lack of information on financial instruments.<sup>31</sup>

### ***C. Alternative Financing Solutions for LAC SMEs***

Various regional schemes could serve as blueprints for counteracting challenges to SME finance. One successful initiative is Chile's FOGAPE, an SME guarantee fund and government initiative to increase access to finance to SMEs by providing partial credit guarantees in order for banks and other lenders to lend to SMEs that lack sufficient collateral to gain access to credit, or that need longer loan maturities.<sup>32</sup> In 2012, FOGAPE financed over 48,000 operations across sectors. In addition to supporting SMEs, FOGAPE backs exporters with at least two years of export experience and annual average export value at or less than \$16.7 million. Originally financed by the government, FOGAPE's operating profits have contributed significantly to its capital base.

Bank credit remains the most important external financing source for SMEs' investments and working capital in the developing world. Due to data limitations, this analysis has focused largely on bank financing. However, bank loans are not the only instrument potentially available to LAC SMEs that wish to export. Given that LAC financial systems are less sophisticated than those in advanced nations or even in emerging East Asia, there is much room for increasing the region's financial depth and catering to exporter SMEs in particular. Even some rather standard instruments such as supplier credit, supply chain financing, and equity financing seem to be used in a relatively limited fashion in Latin America; these could offer important opportunities for the region, including for SME internationalization. Such instruments include the following:

- Supplier credit could expand access to affordable financing among LAC SMEs intending to export because suppliers have fewer information and enforcement problems than do banks. However, as discussed, supplier credit still represents less than 10 percent of LAC SMEs' investments.
- Supply chain finance demand and supply is growing around the world, but only a fraction of SCF needs are being met. This too is an opportunity for Latin America, given the mutual incentive for the large buyer and SME supplier to ensure the supplier's financial health. SCF is growing fashionable in international finance (See Box below), and could also offer important opportunities for LAC SMEs that supply large companies both at home and abroad.<sup>33</sup>
- The role of equity finance for exporters can also be expanded, given the limited access to equity capital in the region and the fact that equity financing will reduce the SMEs' cost of capital and reduce the debt-to-equity ratio, thus strengthening their financial position. The Inter-American Investment Corporation's (part of the IDB Group) new InvestAmericas initiative is one effort to bridge this gap. Moreover, many small firms today are "born-global" companies that need financing early in their lifecycles to start selling to overseas customers, yet they tend to be too inexperienced to be bankable. Canada's export credit agency has a program to bridge the born-globals' financing gap through equity financing, and also offers these firms contacts with overseas buyers (see Box below).

### III. Conclusion

This chapter has showed that access to capital is a key driver of SMEs' growth and export prospects. SMEs with stronger internal cash flows and access to bank credit export earlier than their credit-constrained peers. They also export a wider variety of goods and expand to new export markets, thus shaping the firm's intensive and extensive margin alike. Meanwhile, exporting enhances access to capital. SMEs that succeed in the export game tend to have lower earnings volatility and higher productivity, factors that augur well for accessing financing. This means that exporting is a powerful lever for growth, above and beyond its direct effects on firm productivity. Successful exporters can enjoy a virtuous cycle of productivity growth, stability, and access to credit.

### Supply Chain Finance to Fuel LAC SMEs' Cash Flows

Supply Chain Finance (SCF) has existed for a long time, including in LAC. For example, in 2003 the IDB Group's Inter-American Investment Corporation partnered with Mexico's development bank Nacional Financiera S.N.C. (NAFIN) to extend \$20 million in loan guarantees to help thousands of Mexican SME suppliers.<sup>a</sup> However, the credit constraints in the wake of the financial crisis have made SCF an increasingly attractive option for financing SME suppliers in corporate value chain to enhance suppliers' cash flows.

In SCF, the large buyer helps the SME supplier obtain affordable credit through a bank, or offers a sophisticated corporate solution that uses payments among many participants in the supply chain. Using SCF, the corporate buyer is able to pay SME suppliers faster, thus helping the SMEs to improve cash flow and secure financing at lower cost. This, in turn, fuels the SMEs' operations, making them more stable and reliable and thereby reducing the large buyer's supplier risk. The setup is a win-win-win solution: buyers get term extensions, suppliers secure liquidity, and banks gain access to short-term commercial trade-related transactions.

According to several estimates, only a fraction of the need for global supply chain finance has as yet been met. Several governments have established supply chain finance initiatives in order to incentivize uptake by corporate buyers and banks. In 2011, for example, the US Export-Import Bank approved a \$740 million program to offer guarantees for up to 90 percent of that capacity to support Boeing's US suppliers, which are also indirect US exporters and hence supported by Ex-Im Bank.<sup>b</sup> The initiative is part of Ex-Im Bank's Supply Chain Finance Guarantee Program, which enables suppliers to receive early payment of their accounts receivable that are due from participating exporters, such as Boeing, Caterpillar, and Case Holland, in exchange for a small discount fee that is paid to the lender. Ex-Im Bank provides a 90 percent guarantee of the invoices while the lender (Citibank for Boeing suppliers) assumes 10 percent of the risk.

In the UK, the government reached an agreement in September 2013 with three dozen corporations such as Rolls-Royce, Vodafone, and General Dynamics UK, to boost supply chain finance. The bank is notified by a large company that an invoice has been approved for payment; the bank can then offer a 100 percent immediate advance to the supplier at lower interest rates, knowing that the invoice will ultimately be paid by the large company.

SCF is also being used in Latin America, where SME suppliers often face difficulties in obtaining capital against future receivables. A major challenge in the region is the lack of reliable historical information on suppliers' performance, which impedes banks from evaluating their actual risks in advancing funds based on creditor performance expectations. Petrobras has sought to solve this problem through the ProgreDir Program launched in 2011. The program was created in partnership with the six largest retail banks in Brazil (Banco do Brasil, Bradesco, Caixa Econômica Federal, Itaú, HSBC, and

*(continued on next page)*

### Supply Chain Finance to Fuel LAC SMEs' Cash Flows *(continued)*

Santander) and with the National Oil and Natural Gas Industry Mobilization Program (Prominp); BicBanco, Banrisul, Citibank, and Safra later joined.<sup>c</sup> The program helps SME suppliers access credit backed by future receivables (payment for services yet to be provided or equipment still to be delivered) in their contracts with Petrobras. By the beginning of 2013, the program had completed more than a thousand transactions totaling R\$5.2 billion (\$2.3 billion) to 450 suppliers.<sup>d</sup> Some 85 percent of applicants secured financing and the average cost of borrowing declined by some 20–50 percent, according to some estimates.

In light of the high borrowing costs facing SMEs, SCF is an attractive option for large buyers operating in the LAC region, as well as to their SME suppliers. Governments in the region, along with multilateral development banks, can step in by offering loan guarantees to bank partners and by bringing the various parties together.

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b. "Ex-Im Bank announces \$740 million supply-chain program with The Boeing Company," Export-Import Bank of the United States Press Release, February 17, 2012.

c. See "Progridir soma R\$ 5,2 bilhões em créditos, diz Petrobras," *Exame.com*, 18 February 2013, and "Brazil: Petrobras Releases Supply Chain Finance Program," *LNG World News*, June 7, 2011.

d. "Progridir surpasses the mark of thousand transactions," TOS Internacional Maritima, February 19, 2013 < [http://www.tim-maritima.com.br/en/news/2013/2/progridir\\_surpasses\\_the\\_mark\\_of\\_thousand\\_transactions.3051.htm](http://www.tim-maritima.com.br/en/news/2013/2/progridir_surpasses_the_mark_of_thousand_transactions.3051.htm)>.

Compared to their peers in other developing regions, LAC SMEs tend to have access to bank accounts, and the region's banks are increasingly predisposed to lending to SMEs. However, bank loans have steep costs in LAC. Collateral requirements and net interest margins facing the regional SMEs are among world's highest, limiting SMEs' opportunities for new investments. In addition, LAC SMEs also pay significantly higher interest premia than do large regional firms, and lending to SMEs is still dwarfed by lending to large firms. Meanwhile, equity financing remains scarce in the region. Thus, important challenges and outright market failures remain to be addressed in order that viable LAC SMEs and SME exporters gain access to capital.

LAC's public financial institutions—development banks, public commercial banks, and guarantee funds—have also recently emerged as important complements to private bank financing, and also play a counter-cyclical role in economic downturns. These entities have a role in correcting market

### Filling “Born-global” Companies’ Financing Gap

“Born-global” companies are typically too new and risky to be bankable, and thus often struggle to secure adequate capital required for internationalization. Canada’s export credit agency Export Development Canada (EDC) is addressing this challenge by offering an equity program that targets two types of companies: innovative born-global companies, and later-stage SMEs that want to grow their business through exports.

EDC provides these firms with growth capital investments directly and via co-investments for exporting and international expansion. It also connects Canadian companies to international venture capital and equity fund managers. In addition, the program helps companies develop international relationships, including to senior leaders at large global corporate buyers.

The equity program seeks to bridge the three gaps that internationalizing firms typically face: in financing, networking, and experience. The program has been increasingly oriented toward advanced and clean technologies through venture capital, high-growth companies through middle-market private equity, and the development of emerging market investment strategies. As an example, in January 2011 EDC invested C\$3 million in equity investment in Neuralitic Systems, a Montreal-based mobile and wireless company that was expanding in the emerging markets; the transaction was part of a C\$8 million Series B round of financing with four other private-sector investors.<sup>a</sup> In another example, in July 2012, EDC invested C\$7.5 million in Avrio Ventures Limited Partnership II, a venture capital fund that invests in innovative Canadian food and agricultural companies in the areas of health, wellness, and sustainability.<sup>b</sup>

By the end of 2011, the EDC equity program had made a total of C\$694 million in commitments, including C\$320 million of commitments to next-generation exporters; C\$120 million of commitments to mid-market exporters; and C\$254 million of commitments focused on connecting Canadian companies to emerging market buyers.

<sup>a</sup> Export Development Canada (EDC), “EDC Equity Program makes CAD 3 million investment in Montreal’s Neuralitic Systems,” January 31, 2011.

<sup>b</sup> Export Development Canada (EDC), “EDC commits CAD 7.5 M to venture capital fund for Canadian food and agricultural companies,” July 26, 2012.

failures impacting SMEs, but they too have limited resources and have an aversion to risk. Given the LAC commercial lenders’ bias toward large firms and limited financial development, the region awaits further financial innovations and products tailored to the different segments, including different types of SMEs. This chapter has highlighted the promise of supply chain finance and equity financing to LAC SME exporters. The following chapter details innovative export credit agency practices that can be adopted throughout the region.

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# Innovations in Support Mechanisms for SME Internationalization

# 6

## I. Introduction

Many public entities have developed innovative mechanisms and public-private partnerships to mitigate the obstacles that stand in the way of SME internationalization. In this chapter, we describe 10 of these approaches as applied in different countries outside LAC. These approaches address the following issues:

- Financing for internationalizing SMEs.
- Helping SMEs overcome information barriers.
- Increasing SME internationalization through innovation capacity building.
- Internationalizing the SME workforce.
- Supporting quality insertion of SMEs into global value chains.
- Providing comprehensive export support.

These are not white board concepts: each of the programs in this chapter boasts a multiyear track record. Each also provides what appears to be a unique approach for accelerating SME internationalization.<sup>1</sup> Our hope is that this material stimulates creative thinking and possible adaptation to Latin America and LAC countries.

## II. Ten Innovative Solutions

### A. Financing for Internationalizing SMEs

As discussed in Chapter 5, access to capital is critical for LAC SME exporters. Export credit agencies (ECAs) around the world, including in Latin America, have stepped up their financing, credit enhancements, and loan guarantees to SMEs in the wake of the financial crisis and in response to intensifying global competition. ECAs are estimated to finance or underwrite about \$430 billion of business activity abroad. In 2012, the three largest ECAs by volume (in China, the United States, and South Korea) alone supplied a total of \$99 billion for medium- and long-term official export credit.<sup>2</sup> But there are several smaller ECAs that have adopted a particularly comprehensive and

strong commitment to SMEs in particular. We detail here three such programs, from Northern Europe, North America, and Southern Europe.

### **1. *Finnvera: Comprehensive Focus on SME Internationalization Finance***

Finland's export credit agency Finnvera has taken a comprehensive approach to supporting Finnish SMEs, including the many firms that are exporters.<sup>3</sup> The agency combines SME and entrepreneurship finance with export finance, providing loans, domestic guarantees, venture capital investments, export credit guarantees, and other services associated with export finance. The risks are shared between Finnvera and other financial intermediaries. Finnvera also offers guarantees against political or commercial risks. As of September 2013, the agency had extended SME financing for €2.9 billion in outstanding commitments and €10.9 billion for export finance. The agency has 400 staff members (equivalent to US Export Import Bank) and 30,000 customers. Eligible SMEs are enterprises with fewer than 250 employees with an annual turnover not exceeding €50 million or a balance sheet total not exceeding €43 million.

Finnvera has numerous initiatives exclusively targeted at SMEs. The SME Export Finance Program aims to improve SMEs' knowledge of export finance, and is implemented in close cooperation with banks operating in Finland. Finnvera holds one-day export finance workshops for each participant enterprise and a bank chosen by the enterprise. The emphasis of the program is on real export transactions and solutions for financing them. The program is free of charge, with the exception of training provided by Finnvera's cooperation partners, the Management Institute of Finland MIF and the International Chamber of Commerce.

Another unique initiative geared to SMEs is the Internationalization Loan that finances business operations of Finnish SMEs abroad. The loan may be used when a subsidiary or an affiliated company abroad needs funding for investment, development, or growth; it can also be used to acquire or increase a holding or to raise the share capital in a subsidiary or in an affiliated company abroad. To be eligible for financing, the subsidiary or affiliate abroad must primarily engage in production, assembly, maintenance, or service; sales offices do not qualify. Post-investment, the borrower must hold at least 20 percent of the voting rights in the company.

Recognizing that internationalization may require that investments be made in Finland, Finnvera also provides investment and working capital loans for newly established and existing enterprises to finance investments in

buildings, machinery, and equipment and to provide working capital needed because of growth.

## ***2. Export Development Canada: One-Stop-Shop Financing, Contacts, and Actionable Advice***

Another example of a comprehensive and strong commitment to supporting exporters is Export Development Canada (EDC), Canada's export credit agency.<sup>4</sup> The EDC's large staff of approximately 1,200 serves the country's 45,000 exporters. Unlike most export credit agencies that rely on annual appropriations, the EDC is financially self-sufficient and operates much like a commercial institution.

The EDC combines financing instruments as well as advisory capabilities. It offers exporters standard ECA financing instruments: trade credit insurance and bonding solutions, export working capital loan guarantees, and foreign buyer financing. However, like Finnvera, EDC also supports Canadian companies that invest abroad through the Canadian Direct Investment Abroad (CDIA) program, which offers a wide range of solutions to help Canadian companies obtain financing for their foreign affiliates and subsidiaries, and to research foreign markets. The CDIA program is based on an EDC study that found that foreign investments made by Canadian companies are complementary to exports and growth in Canada because they result in more sales, lower costs, greater productivity, improved market penetration, and better customer service.

EDC also accommodates born-global companies and nascent SMEs that typically struggle to access adequate debt financing from banks for exporting and international expansion, and which lack the types of contacts that large companies might have in international markets. The challenges facing born-global firms were described more fully in Chapter 4 of this report. EDC provides these firms with equity funding, either directly or via co-investments with equity funds; introductions to international venture capital and equity fund managers; and senior-level international relationships, including to senior leaders at large global corporate buyers. By the end of 2011, the equity program had committed nearly C\$700 million.

EDC also offers advice and information to Canadian exporters. For example, on a site called EXPORTCheck, Canadian exporters pay C\$30 for valuable financial and credit information on its US and foreign customers using an online database covering millions of companies. EDC also runs webinars on financing and risks involved in cross-border commercial

transactions. It also informs about seminars for exporters offered by other entities in Canada. In addition, EDC runs a research panel among Canadian companies. The panel participants join monthly surveys on such topics as the effects of currency fluctuations, border-crossing times, business developments in Canada and abroad, and new resources to meet exporters' international business needs.

### ***3. Malta Enterprises: Incentivizing Early Stage Exporters and Suppliers***

Malta's Malta Enterprises offers a suite of financial products for companies designed for four key business activities: idea generation and development, planning, implementation and financing, and growth and internationalization.<sup>5</sup>

Malta Enterprises' program, offered in 2010–2013, was aimed at supporting born-global start-ups in manufacturing, IT, waste treatment, eco-innovations, biotech, and other sectors that have international growth potential and/or potential to collaborate with large enterprises. The start-ups would also be commercially and technologically feasible and have the knowledge base necessary for growth. According to Malta Enterprises' online descriptions, the initiative provided both cash grants for up to €15,000 and loan guarantees for up to €250,000 for up to 10 years. The financing was more generous the greater the start-up's international potential. These internationalizing firms also gained access to counseling by Malta Enterprises officials and were supported by meeting facilities, office equipment, administrative services, and local and foreign networking events. Malta Enterprises partnered with a local incubator to run the program.

Malta Enterprises also supports measures to enable SMEs to meet international standards, both to export and to access value chains. In another program called Quality+, Malta Enterprises offers incentives to SMEs to continuously improve the quality of their products, services, and processes through attaining international quality and environmental certifications and licenses required for participation in value chains. The incentive covers a maximum of €20,000 in eligible costs. Malta Enterprises may approve a tax deduction from eligible taxable income equivalent to 150 percent of the eligible costs over any normal statutory tax deductions.

In yet another initiative, Malta Enterprises supports micro, small, and medium-sized companies for a total of €10,000 in one calendar year to provide them with access to experts and to participate in international fairs as exhibitors. The financing covers up to 50 percent of costs directly related to renting, setting up, and running a stand, and up to 50 percent of travel

expenses incurred by one person representing the company during a fair or exhibition.

Malta formerly offered a royalty financing scheme to facilitate financing to early stage firms and internationalizing SMEs. This approach accommodated the often lumpy revenue streams that exporters have.

## **B. Helping SMEs Overcome Information Barriers**

Exporting is an information-intensive activity. As explored in Chapter 3 of this report, this constrains LAC SME exports in two ways. On the one hand, it is often difficult for SMEs to identify, collect, and analyze information on markets, operations, logistics, and partnerships essential to successful overseas sales. On the other hand, overseas buyers often lack information on the quality of SME products, an image problem that plagues SMEs from developing countries in particular. Both aspects can add significant sunk and ongoing costs for LAC SME exporters, as well as the need to upgrade internal capabilities. Following are two mechanisms designed to overcome one or the other side of the information barrier, one from Central Europe and the other from Southeast Asia, respectively:

### **1. *CzechTrade's Business Info Portal: One-Stop-Shop Information Repository for SMEs***

In all too many cases, information that SMEs need to grow their businesses and export are provided by many government and NGO institutions. The details involved in setting standards, establishing regulations, and managing logistics must often be pieced together by SMEs through their own extensive research. The search for information is not a one-time event; it takes place repeatedly and in varied forms as a firm internationalizes, which compounds the seriousness and cost of the challenge.

The Czech government addressed this problem by creating an integrated web portal to serve the Czech SME business community's information needs. BusinessInfo.cz integrates content from a variety of government entities, not-for-profit associations, and business chambers.<sup>6</sup> Registered users of the site jumped by a multiple of 52 in five years, from just 306 in 2002 to 15,958 in 2006. Meanwhile the number of visitors to the portal increased from 6,642 to 146,472, or over 22 times.<sup>7</sup>

The portal covers guidelines, forms and points of contact to start a business, manage a business, expand within the EU, expand outside of the EU, and exit a business. Additionally, marketing, innovation, and finance/

investment all receive specialized coverage emphasizing the needs of entrepreneurs, as do market access issues such as standards and IP protection.

An important element of the portal, also accessible through the CzechTrade website, is a database containing some 5,000 export and internationalization opportunities annually. Searches can be conducted in three categories: foreign inquiries, foreign projects and tenders, and foreign investment opportunities. These are collected by CzechTrade offices overseas, Czech embassies, and online data forms. Opportunities are then categorized by sector and translated into Czech. According to the European Commission, online visits to the database ranged from 20,000 to 100,000 per month as of 2008.

## ***2. The Malaysia Kitchen Programme: Boosting Cultural Image to Increase Food-Related Exports and Tourism***

Many sectors in developing countries have a low profile in world markets. This reputation void often affects SMEs more than it does large companies because they are largely unknown in export markets and at the same time lack resources to build their brands. The Malaysia Kitchen Programme (MKP) was sponsored by the Malaysian government to promote Malaysian restaurants overseas and Malaysian food and cultural offerings at home. MKP aims to build export demand within sectors related to the country's cuisine and culture by increasing awareness and patronage at participating restaurants in order to increase sales of Malaysian food ingredients, agricultural produce, processed foods, and tourism offerings.<sup>8</sup>

The program uses a multifaceted approach for addressing country and country-sectoral brand image while creating and leveraging relationships with chefs and restaurant owners, who constitute a specialized group within the Malaysian Diaspora. Several consumer information and educational tools have been developed, including the following:

- Focused PR initiatives, such as restaurant reviews by known travel writers and novelists as well as evaluation by international restaurant rating agencies.
- Exposure at international gastronomic events such as trade shows, cookery programs, and demonstrations.
- An integrated digital media platform, with an umbrella portal as well as local websites specific to London, Australia, and New Zealand, and some links on New York and Canadian affiliate sites.

- A variety of marketing collaterals distributed in print at events and through the portal.

MKP's content-rich digital platform is designed as a gateway to Malaysian cuisine, its history, and people. Viewers can use search tools to find restaurants throughout Asia, Europe, North America, and Oceania, and download recipes by type of dish. Blogs, event links, and promotional offers on the MKP destination-specific sites provide new content at periodic intervals, along with social media presence. The site further offers visual appeal, attractive layout, color selection, photo galleries, and videos. These elements offer a good example of web presence that is clearly customer-driven, to fulfill its branding objective, and yet can be executed and maintained cost-effectively.

### ***C. Increasing SME Internationalization through Innovation Capacity Building***

Strong organizational capabilities in product and technology innovation significantly increase the odds of success for LAC SME internationalization whether in export markets or through supplier relationships within GVCs. Yet only a relatively small percentage of SMEs from developing regions, including Latin America, possess the innovation capability needed to compete globally.<sup>9</sup>

By linking innovation programs with other support to exporters and suppliers, public interventions can address more than one element of the challenge at once. Two solutions developed and implemented in Norway provide insight on moving the needle.<sup>10</sup>

The first of these was a three-year program (2001–2003) to accelerate exporting through market and/or technology innovation carried out by two Norwegian county-level councils. SMEs participated in a 12–14 month innovation capacity building program with government financial support and through extensive coordination that included county and community councils, Innovation Norway (Norway's central economic development agency and trade representative), regional chambers of commerce, export associations, community and county councils, research and education institutions, and private consultants.

This program was organized in four phases: a readiness assessment; an analysis of the SME's abilities and opportunities for market and technology innovation; project planning for the chosen innovation; and customized implementation for the SME through advisory, networking, financing,

and other services. Follow-up evaluation revealed that, with over 300 SMEs undergoing at least one program activity, participating firms increased their export sales by an average of 7 percent.

The second mechanism focused on SME suppliers to large firms within global value chains. This program sought to strengthen the innovative capabilities of SME suppliers through close collaboration with leading multinational partners (typically but not exclusively based overseas). The approach was premised on the idea that enhanced cooperation within the GVC can substantially increase the odds for local suppliers to meet and benefit from the stringent demands of their large customer.

To simulate innovation-oriented collaboration, Innovation Norway provided both a legal vehicle and partial financing for the co-development of a new state-of-the-art product, service, or process by one or more Norwegian suppliers together with a customer with a prominent industry reputation and broad market access. The format was an industrial research and development contract, which served as a binding agreement among the parties, and which Innovation Norway granted only to projects that were innovative, created value, and had market potential. Although intended predominantly for SME suppliers, who were eligible for grants of up to 35 percent of their costs, non-SME suppliers were also included, with Innovation Norway offsetting up to 25 percent of costs.

From 1995 to 2005, more than 1200 projects were financed. Of these, 12 percent were found to have failed and 44 percent were judged a commercial success. According to this same government evaluation, overall sales from the new offerings, including exports, totaled more than NOK1.4 billion by 2007, or at least the value of the grants awarded up to 2005.

#### ***D. Internationalizing the SME Workforce***

Internationally savvy managers and employees play a major role in providing SMEs with the mindset, knowledge, and contacts required for successful export initiatives. Yet many SMEs do not have access to internationally skilled staff. In 2010, the European Commission highlighted this issue in its Europe 2020 strategy with an educational policy initiative focused on “mobility, vocational training abroad for young people to improve their foreign language proficiency, foreign market and work know-how, and intercultural competencies.”<sup>11</sup>

Germany’s Training without Borders program, conceived of and operationalized by a broad public-private partnership, is a prime example



of the mobility approach.<sup>12</sup> It is intended to help smaller enterprises access and develop personnel with international experience. The program especially targets the crafts and skilled services sectors, in which about 50,000 German enterprises are engaged in international markets, usually in neighboring countries. The message for LAC SMEs is clear: while some service sectors, such as those related to manufacturing or delivering professional offerings, have jumped onto the global scene, other service businesses that are more local in nature often encounter difficulties scaling globally due to a lack of internationally oriented personnel. On their own, these firms may be unable to organize cross-border training opportunities for staff.

Begun in 2009, Training without Borders is supported by roughly 40 chambers of commerce in Germany as well as the Federal Ministry of Labor and Social Affairs. The chambers (through a national network of over 35 mobility coaches) provide member companies with education and advice on sending trainees and young workers abroad, including practical support such as costs, funding facilities, insurance coverage, contractual provisions and suitable foreign partners. The mobility coaches also work directly with the trainers and young workers to prepare for their international assignments. A database and intranet platform round out the provision of guidelines and help to standardize quality.

In 2010, about 1,500 young people completed part of their training abroad with help from the program, and about 500 young people from other parts of Europe trained with companies in Germany. A survey conducted in the second half of 2010 showed that the program was off to a good start. Nearly 90 percent of enterprises responding indicated a strong interest in sending their trainees abroad, and nearly 50 percent were willing to take in foreign trainees. Between about 80 and 90 percent of those responding reported that their willingness to place trainees had increased as a result of mobility coaching, that they were very satisfied or satisfied with the services provided, and that their overall experience was positive or very positive.

The survey also pointed to areas for further improvement. For example, more than two-thirds of the businesses asked the chambers to take more of an active role. While somewhat more than 40 percent of the businesses had placed their trainees abroad, this number dropped to less than 15 percent for skilled workers, perhaps because workers were unwilling to leave their jobs for weeks or months at a time.

### ***E. Supporting Quality Insertion of SMEs into Global Value Chains***

For LAC SMEs, plugging into global value chains by supplying large firms can bring multiple benefits, enabling SMEs to build internal capabilities, understand and meet rigorous global standards, produce larger volumes, harness scale economies, and ramp up internationalization. But many barriers stand in the way. These barriers include difficulties in finding and establishing trusted relationships with lead firms, making both up-front and ongoing commitments of managerial and technological resources, and limited working capital and investment capital.

As a result, numerous backwards linkage programs have been used worldwide to connect large and typically global firms with SME suppliers in ways intended to strengthen SME capabilities and opportunities. Some of these programs have been carried out by public entities or international organizations; others are managed by multinationals themselves or by public-private partnerships. Collaboration of multiple stakeholders lies at the root of this approach, giving rise to variable results from different efforts depending in part on the quality of the participatory framework. One of the most successful examples was Ireland's National Linkages Programme (NLP), which was designed to maximize local sourcing by manufacturing industries and which ran for more than a decade starting in 1985.<sup>13</sup>

The NLP worked both sides of the equation. It targeted multinational companies to help them identify potential Irish suppliers, while at the same time working with local firms to build capabilities, know-how, and capacity. Lead firms were courted with the message that Ireland would become a major component of their overall European footprint and a part of their more general supply strategies. SMEs were rigorously evaluated, not on their current capabilities, but rather on their potential to improve technically, financially, and managerially. In fact, of the roughly 300 companies that applied in the first round, only about 60 firms were selected. As a result of the program, Irish SMEs upgraded and became suppliers to such companies as IBM, Apple, and Dell.

Key success factors included the following:

- **Close cooperation with lead firms.** NLP worked closely with multinationals and large Irish firms to identify new business opportunities for local suppliers, monitor high-impact trends, and establish and communicate criteria for successful supplier relationships.

- **Development of the supplier base.** NLP SMEs were accepted into the program with a range of assistance in areas such as operational management, quality control, logistics, finance, technology, and marketing. It also formed international procurement panels, giving SME suppliers a foothold into export markets.
- **Spurring strategic partnerships.** The program encouraged the formation of strategic alliances and joint ventures that went beyond traditional supplier-lead firm relationships.

## ***F. Providing Comprehensive Export Support***

### ***1. Singapore's Global Company Partnership: Customizing Solutions for Each Firm***

With its stunning success in exporting and high dependence on trade flows, Singapore is often cited as a role model for public sector intervention in internationalization.

According to International Enterprise Singapore—the government agency tasked with spearheading overseas growth of Singaporean companies—firms with the potential to stake out a competitive leadership position globally or regionally are the engines of the country's long-term growth prospects, economic resilience, and high-value jobs. Accordingly, IE Singapore takes a highly structured and consultative approach to supporting companies that can demonstrate global aspirations, competitive offerings, and a clear plan for internationalization that will provide economic benefit to the country.

The framework that binds this approach together, called the Global Company Partnership, begins with an intensive evaluation and customized plan, followed by a suite of solutions to plug identified gaps.<sup>14</sup> Participating firms may be of any size or sector. Typically, those accepted into the program have some prior history abroad, but this is not a hard-and-fast requirement. Micro-enterprises and start-ups are not eligible: companies must show at least \$500,000 in revenue, a minimum of three years business spending, and three or more management staff.

IE Singapore carries out what it describes as a comprehensive evaluation and planning process. The first step is to understand the firm's business strategies, products and services, and plans for overseas growth. Second, the agency and firm assess potential sectors within different markets and competitive landscapes, prioritizing opportunities for growth. This is the stage

where gaps in capabilities are identified. IE Singapore then recommends a custom set of solutions in any or all of four major arenas: capability building, market access, workforce development, and access to financing.

Within each category, IE Singapore can provide a considerable range of assistance, including the following:

- **Capacity building for global growth.** Included are strategy, branding, design, finance, intellectual property management, supply chain management, and e-commerce. IE Singapore recommends specialized clinics, seminars, or third-party consultants, depending on firm need. The government co-funds up to 50 percent of eligible third-party costs.
- **Market access.** As with many EPAs, IE Singapore provides industry-specific market reports and direct connections through its offices worldwide. Unlike some others, this is augmented by high-level business forums with leaders in Africa, Latin America, and Abu Dhabi, and bilateral business councils in China. They also help firms by offsetting sunk costs of entering new markets and/or expanding within international markets. For example, the government will fund up to 50 percent of eligible third-party consultancy costs for enhancing market presence in any market, such as the costs for market research, feasibility studies, testing, and bidding. It will also take on some of the costs of IP registration, in-market certifications, and other entry costs. Certain market expansion and investment activities are eligible for a 200 percent tax deduction.
- **Workforce development.** This GCP component assists with talent recruitment and attraction through co-funding of scholarships and overseas internships; development of existing staff with up to 50 percent funding on overseas immersion and customized training programs; up to 70 percent of international leadership programs; and up to 50 percent funding of international human resource consulting costs to establish strategies for in-market HR and cross-border management needs and compliance.
- **Access to financing.** In addition to the financing mechanisms mentioned above, four other IE Singapore credit enhancement programs serve GCP companies. An internationalization finance scheme underwrites a company's insolvency risks with participating financial institutions, who are then able to extend mid- to long-term facilities for fixed asset purchases, working capital, and banker's guarantees on

overseas projects. Similarly, a loan insurance scheme increases the capacity of participating financial institutions to extend short-term trade financing facilities for inventory, factoring, and receivables. A political risk insurance scheme co-funds up to 50 percent of a company's political risk insurance policy premiums. A trade credit insurance scheme protects companies against non-payment when extending credit to buyers, with the government co-funding up to 50 percent of trade credit insurance policy premiums.

Public-private partnerships are a key feature of the GCP. No matter the focus, the government does not deliver the solution but rather acts to facilitate and deepen connections between internationalizing firms and vetted private sector providers.

## ***2. New Zealand Trade and Enterprise: Integrating the Full Chain of Support Under One Roof***

New Zealand Trade and Enterprise (NZTE)'s impressive record of success in innovating and carrying out initiatives through its one-stop-shop approach were recognized at the 2008 World Trade Promotion Organization Conference, where NZTE was judged the world's best trade promotion agency.<sup>15</sup>

New Zealand Trade and Enterprise, the government's trade and economic development agency, was created in 2003 to address the spectrum of business needs in internationalizing, from refining strategy and improving operational performance to determining how to succeed in export markets and building the necessary customer information and commercial networks.

The approach eliminates the fragmentation of support that can otherwise divide trade-related and business capacity-building efforts across government entities. Instead, NZTE is equipped to design, deliver, market, and monitor all key elements of integrated trade promotion and assistance to New Zealand businesses. NZTE also oversees government services to promote investing and locating in New Zealand and buying from New Zealand firms, thus providing additional opportunities to enhance SME internationalization as suppliers to international firms.<sup>16</sup>

The agency supports 1,500–2,000 businesses at any one time and focuses intensively on about 500 of them. In addition to its domestic staff, the agency works through 36 international offices that provide hands-on support through alliances and relationships, and its economic development, regional business, and advisory partners within New Zealand.

According to NZTE, the agency's services are delivered as part of a comprehensive and typically multiyear plan specific to each company's international initiative, timeframe, and scale. Support to coalitions of firms is prioritized. Unlike trade promotion organizations in many countries, NZTE provides information and services designed for start-up and growth-stage firms, as well as businesses in the services sectors and Maori-owned (ethnic minority) businesses. In this way, all SMEs may benefit if deemed potentially competitive in international markets.

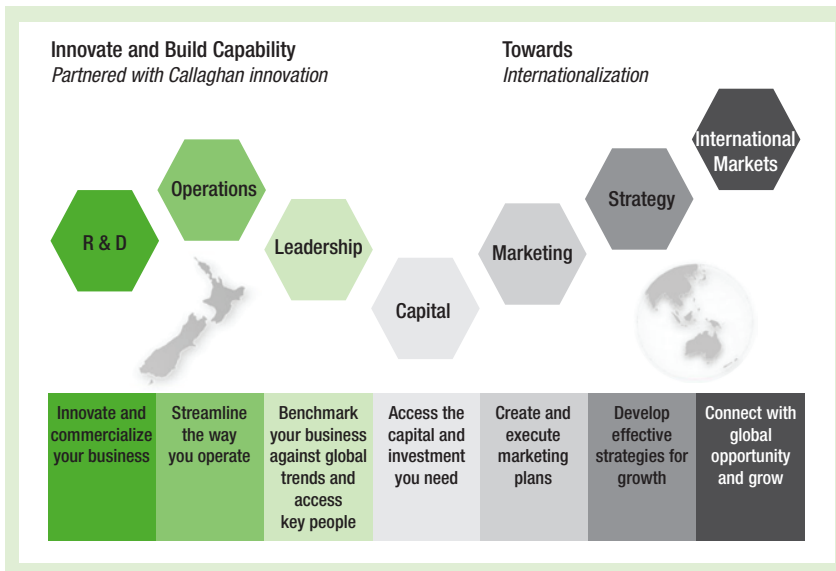
In line with this philosophy, NZTE programs appear particularly robust. They cover the following:

- **Access to finance.** Information for a wide variety of business needs regarding options, demands, and processes to raise money, including connections to capital networks domestically and overseas.
- **Business strategy and innovation.** Workshops on management approaches, models, and tools to enhance value creation; links to volunteer and fee-based business mentoring opportunities; partnership with incubation support programs for early-stage technologies and businesses; and a capacity-building program designed to foster innovation, branding, and customer insights.
- **Systems and processes.** Coursework, consulting, training and peer forums to identify, plan for, and correct operational improvements.
- **Exporting.** Strategic advice and mentoring delivered by specific to multiple world regions; additional in-market services including strategic, marketing, and tactical connections and insight; online information guide on the export process as well as online and customized market research; competitive program for 45–60 participants annually to fast-track entry and penetration of export markets via industry-specific training, advice, feedback, and an in-market visit; regional business partner program, including training and capacity building, specific to SME internationalization.
- **Reputation in world markets.** Program to repair the international image of the New Zealand dairy industry in the wake of reports of potential product contamination; linkages to New Zealand International Business Awards to build credibility.
- **Diaspora relationships.** Outreach and motivation of 100,000 Kiwis and “friends of New Zealand” in 175 countries to assist New

Zealand businesses, including a separate organization for prominent individuals.

- **Supplier relationships.** Procurement advice and early-stage access to Australian and New Zealand projects; specialty advice on supplier capacity building; and a regional business partner program, including training and capacity building specific to SME internationalization.

As the following NZTE diagram shows, assistance for many young and small companies aims to strengthen their competitive foundation, readying these companies to begin exporting after they achieve the capabilities for generating and sustaining growth.



**SERVICES DESIGNED TO MEET COMPANY GROWTH NEEDS**

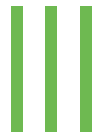
## Endnotes

- 1 Note that metrics are not easily obtainable on all programs; where available, these are shared in the chapter. Similarly we note whether a program is in current operations.
- 2 Ezell, S. “Top Competitors Continue to Outinvest the United States in Export Credit Financing,” November 6, 2013 <http://www.innovationfiles.org/top-competitors-continue-to-outinvest-the-united-states-in-export-credit-financing/>.
- 3 Information based on Finnvera’s site <http://www.finnvera.fi/eng> (accessed November 20, 2013).
- 4 Information largely based on EDC’s site <http://www.edc.ca/EN/Pages/default.aspx> (accessed November 20, 2013).
- 5 Information based on Malta Enterprises site <http://www.maltaenterprise.com/en/support> (accessed November 24, 2013).
- 6 Information based on [www.businessinfo.cz](http://www.businessinfo.cz) and [www.czechtrade.cz](http://www.czechtrade.cz) (accessed December 4, 2013).
- 7 European Commission Directorate-General on Enterprise and Industry (2008). *Supporting the Internationalization of SMEs – Good practice Selection*.
- 8 Information based on MATRADE website <http://www.matrade.gov.my/en/malaysian-exporters/services-for-exporters/export-promotion/malaysia-kitchen-programme>, and Malaysia Kitchen of the World websites <http://www.malaysiakitchen.my/> (accessed November 27, 2013)
- 9 See for example Caniels and Romijn, 2003.
- 10 European Commission Directorate-General on Enterprise and Industry (2008). *Supporting the Internationalization of SMEs – Good Practice Selection*.
- 11 German Federal Ministry of Labor and Social Affairs, European Social Fund for Germany and the European Union: “Chambers coaching network promotes cross-border mobility: Interim review of the programme “Training without Borders”” (2012).
- 12 Ibid.
- 13 *The International Fragmentation of Production: Latin America and the Caribbean in the Era of Global Value Chains*. Special Report on Integration and Trade, Inter-American Development Bank, Forthcoming UNCTAD (November 2006), “Developing Business Linkages: Note by the UNCTAD secretariat.”
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# **High-Potential Strategies for Accelerating Internationalization among LAC SMEs**

SECTION





Section I of this report showed that an increase in LAC SME internationalization can increase national exports, economic growth, and development. Internationalized SMEs are not only better companies that self-select into exporting; they become even better by virtue of exporting and/or supplying global value chains. Internationalized LAC SMEs have greater scale, revenue diversification, and stability than their domestic-only counterparts. They also employ more people, add more value per worker, and pay higher wages. As they grow, they can employ additional people and generate jobs in related businesses upstream and downstream. LAC SMEs that survive for a number of years in export markets contribute strongly to their countries' export diversification and export growth; they can also help create export ecosystems, by inspiring non-exporters to become exporters. For these reasons, it generally makes good policy sense to assist LAC SMEs that have the potential to compete sustainably in global markets.

Providing effective assistance is a complex task. Support to SMEs must overcome challenges that slow, prevent, or halt SMEs from growing through internationalization. In Section II, we explored these bottlenecks. We saw that small and medium-sized enterprises face external obstacles, including entry costs, trade costs, trade compliance issues, and informational barriers, and require that firms address a number of internal requirements for successful internationalization. SMEs also face difficulties in accessing affordable credit. Many SMEs lack an understanding of where and how best to focus their efforts. Meanwhile, time lags between financial outlays and business outcomes can be extensive.

In this section we present ways to address challenges that impede LAC SME internationalization that will enhance the focus and impact of support activities and resources. This section is organized as follows:

- **Innovations in support mechanisms.** A set of distinctive public sector practices drawn from countries outside of the region and aimed at mitigating diverse, priority obstacles to SME internationalization.
- **Accelerating LAC SME quality participation in global value chains.** Opportunities, challenges, and further steps to increase the benefits accruing to SMEs from the large presence of multinationals in the region.
- **Leveraging the US Hispanic Diaspora to drive LAC SME exports.** Specific ways to help LAC SMEs do more business in one of the largest and fastest growing markets worldwide—a market committed to cultural relevancy and the Spanish language.

- **Helping SMEs leverage cross-border e-commerce.** Opportunity and policies needed to boost LAC SME use of the Internet to understand, reach, and sell in global markets.

These are not the only possible approaches, nor have they been subjected to the systematic evaluation and cost-benefit analysis that would take place next. Rather, each of these strategies has a high potential for returns because each is of particular relevance to SMEs in Latin America and the Caribbean given the region's unique opportunities and challenges. In addition, each responds to current developments in the global competitive environment, provides a path to focus a portion of public resources on an integrated approach, and is immediately actionable.

Taken as a whole, these strategies benefit a range of regional SMEs, whether by sector, country of origin, and/or stage of internationalization, and present a diversified menu of options to enhance the odds of success. Our hope is that this material stimulates possible fresh thinking about internationalization support to regional SMEs.

# Accelerating LAC SME Quality Participation in Global Value Chains

## 7

### I. Strategic Rationale

This chapter addresses the means to leverage a decisive change in international trade and production patterns in order to systematically benefit the region's SMEs. Accelerating LAC SME quality participation in global value chains (GVCs) holds great promise for the region. But the opportunity for doing so is hampered by a variety of challenges and outright market failures. For these reasons, assisting LAC SMEs in accessing and benefiting from GVCs should be considered as one of the region's key internationalization strategies.

For the first time, developing economies in 2012 attracted more foreign direct investment (52 percent) than developed economies.<sup>1</sup> The size of the opportunity alone is staggering. As of 2010, 57 percent of all global economies and 40 percent of LAC economies participated in GVCs. Worldwide growth rates from 2005 to 2010 were 4.5 percent, and in the region, 4.9 percent.<sup>2</sup> Due to relentless expansion of GVCs, intermediate goods exports in 2012 exceeded the total of final and capital goods exports worldwide for the first time ever.<sup>3</sup> Recent research shows, moreover, that developing economies with effective GVC participation can increase GDP per capita growth by 2 percent above average.

LAC has a substantial and growing number of multilatinas and foreign multinationals. Yet regional SMEs often struggle to take advantage of this path to internationalization.<sup>4</sup> To create and maintain the relationship, suppliers must constantly prove and improve their quality, communications, and innovation capabilities in order to regularly drive down cost, specialize, and adapt. They must also deal with product networks that are morphing at daunting rates, with far higher sophistication and coordination required across inter- and intra-firm transactions, and rapidly shifting geographic configurations made possible by leaps in information and communications technologies.

For LAC SMEs, plugging into global value chains by supplying giant firms may bring multiple benefits: supplying one or more extremely large customers can enable an SME to produce larger volumes, harness scale economies, and reduce overall enterprise risk. The supplier may also benefit by

accessing important information flows about products, markets, and customers through technology transfers and by exposure to new managerial practices.

The broader benefits to LAC economies can also be major. Research shows that as individual SME suppliers gain from learning opportunities with large and/or global firms, they can generate knowledge spillovers and stimulate human and technological capital upgrading in other firms. Such knowledge spillovers do not happen automatically, nor do they occur in every instance. Note that the primary force in this virtuous cycle is the interaction between the multinational and local suppliers, whereby the process of learning and capability acquisition leads to upgrading that may benefit other local firms. For example, this may take place through high-skilled labor turnover as well as export enhancing effects in upstream sectors of the supply chain.

Such spillovers are not generally included in the lead firm's private assessment of costs and benefits of investing in its GVCs. This means that the multinational may invest less than what would be socially optimal. Additionally, sectors with stronger and more diversified linkages to the rest of the economy tend to produce more spillovers. Finally, it has been shown that upgrading, and thus spillovers, is more likely to occur when the technological gap between the domestic supplier and the MNC is neither too big nor too small; in this way, the local firm has much to learn and also a capacity to learn more.<sup>5</sup> These and other gaps between private and social returns may be bridged by certain forms of public intervention.

Faced with these dynamics, many discussions of internationalization policy have centered on how a country or region can acquire the largest piece of international value-added by influencing lead firms in their GVC location and investment decisions. Our focus here is different. Given that local firms can accrue long-term advantage through participation in GVCs, we seek to address the following questions: when these linkages strongly benefit SMEs, how have they been formed? What is the particular set of conditions that shapes the quality of participation? Considering today's value chain dynamics and their continuing transformation, what can be done to help LAC SMEs grow via GVC participation?

From the perspective of LAC SME suppliers, the rapidly changing GVC landscape has created multiple sets of potential customers and ever higher demands on capabilities, performance, and capital, in addition to new opportunities for profitable niche specialization. However, growth through this

internationalization trajectory has not been simple to capture. We explore the potential benefits and challenges facing current and would-be regional suppliers in Part II and Part III. We then use this lens in Part IV to suggest practical steps towards realizing a strategy of constructive participation.

## II. Benefits to LAC SMEs: A Closer Look at the Ideal

Global value chains vary a great deal, depending on what they produce, how they are configured, and where they are located. They can involve high or low turnover, feed relatively smaller or larger markets, be producer- or consumer-driven,<sup>6</sup> and require relatively greater or fewer intermediate inputs. GVCs occupy a central role in any number of sectors important to LAC, among them, electronics, IT, textiles, agribusiness, and natural resources.

And yet, despite all this variation, it is possible to generalize about the gains SMEs make through long-term success in supplying production networks:

- GVCs may provide SMEs with far more access to capabilities and knowledge than what might otherwise be available in the domestic economy.
- Participation may ensure that products, services, and enabling capabilities and technologies are up-to-date and in many cases world-class.
- Selling to a multinational or other large firm that is located within the same country eliminates many of the issues of risk, access, and barriers to entry associated with exporting.
- Lead firms and their tier-one global suppliers can play a definitive role in assuring that the supplier base meets rigorous quality standards and delivery times and upgrades production and delivery capabilities. Assistance may take the form of supplier development programs such as in-house training, active information exchange, certification training and support, credit financing, and direct capital investments.
- In rarer situations, participation may lead to functional upgrading by moving to a higher level within the GVC by expanding the types and sophistication of the SME's business activities. Or an SME can benefit from inter-sectoral upgrading by serving a new sector based on capabilities acquired from participation in the GVC. While these scenarios occur rarely, success stories can be striking. In one such case, Torreon Mexico succeeded in upgrading its blue jeans production from *maquila*

to full-package manufacturing.<sup>7</sup> Similarly, the Taiwanese television industry embarked on inter-sectoral upgrading to produce screens for the computer sector.<sup>8</sup>

Nor are the general gains to SMEs from GVC participation limited to firms that trade in goods. SMEs in the services sector are strong contributors to and beneficiaries of GVCs. Particularly important are producer services: transport, communications, finance, distribution, and business services. These services can now be incorporated in products as traded inputs, bundled into composite products, or separated out entirely from manufacturing enterprises. The trend is powerful and growing, giving rise to the term “servicification,” i.e., the increased use of services in manufacturing alongside production processes and sales. Further, unlike the customized goods that function as intermediate inputs, some of these services can be provided to multiple large customers within the same market to both rival firms as well as customers of lead manufacturers.<sup>9</sup>

The ubiquity of services within GVCs means that enhanced GVC participation can generate growth across a very wide swath of LAC SMEs. This opportunity is all the more striking given that the share of services value-added in world gross domestic product grew from 53 percent in 1970 to 70 percent in 2010. In many LAC economies, the share of GDP attributable to services in 2012 was greater than that of manufacturing, agriculture, and mining combined.<sup>10</sup>

Case study research involving some 100 Mexican SMEs confirms the opportunity for significant upgrading within global value chains, and at the same time highlights potential differences among sectors.<sup>11</sup> Metal mechanics and logistics firms that became trusted suppliers to MNCs assumed control of long-term projects with high technical complexity. As the relationship progressed, the MNC invested in infrastructure and equipment to ascertain that the supplier could meet ongoing demand and eventually participate in projects to design and manufacture new industrial equipment.

As a result, the long-term suppliers developed either high flexibility in services of high complexity (logistics firms) or high specialization that allows for mass production of high or intermediate technology products (metal mechanics). Further, some of the logistics firms developed new organizational, communications, and management capabilities with support from the MNC. This support enabled them to evolve beyond training and



### **The Rise of 'Servicification' in Manufacturing GVCs: An Acceleration of Services beyond Production Processes and Sales**

Firms in the services sector are fast becoming strong beneficiaries of GVC insertion. In fact, services are often separately traded inputs. Moreover, the producer services—transport, communications, finance, distribution, and business services—provide important opportunities to SMEs to sell to multiple large customers. A case study of a Scandinavian firm, Sandvik Tools, illustrates the scope of these activities.

At the time of this study, Sandvik Tools used 40 discrete services to manage its supply chain. Among them were legal services, taxation services; medical services; maintenance and repair; security services; packaging; printing; publishing, design, building cleaning, audiovisual services, banking services, courier services, freight transport, and energy services.

An additional 12 services were required to manage customer delivery. Some of these were computer services, rental and leasing, technical testing and analysis services, environmental services, financial services, logistics, and warehouse services.

Depending on the product, significant after-sales services also may be offered as a means of product differentiation and profit. Such services can include technical assistance and training, maintenance, provision of spare parts, and repair services.

*Adapted from Low, Partrick, "The role of services in global value chains". Global value chain in a changing world. WTO, Fung Global Institute, Temasek Foundation Centre for Trade and Negotiation, . 2013.*

logistics to include a wide range of professional services such as certification processes, IPA, technology management, auditing, digital commerce, recruitment and more. Despite laying the foundation for revenue diversification, both sets of SMEs continued to sell predominantly to the lead MNC (averaging 61 percent to 68 percent of sales).

The IT firms interviewed in the Mexican case study followed a different trajectory. Representing such subsectors as software development, systems integration, telecom equipment, and mobile devices, these companies built their GVC relationships as either specialized providers of tailored products and services, or through sales of their own branded products. Investment typically did not come from the GVC, but rather, from various combinations of support from friends, family, government funds and innovation programs, incubators, and small business associations, including mergers. As a result, their sales to the lead MNC averaged 42 percent of their total sales, with remaining revenues derived mainly from local or national clients.

In sum, the value of GVC participation for LAC SMEs can be profound. Nonetheless, in both quantity and quality, these relationships have often fallen short of the ideal. In the next part, we examine the key bottlenecks in order to assess where the strategy faces some of its greatest challenges.

### **III. Challenges Facing LAC SMEs in Accessing and Benefiting from GVCs**

#### ***A. An Uneven Track Record: The SME Supplier Experience in Developing Economies***

As we have seen, benefits to SMEs from participation in GVCs can run the gamut: reliable and increased sales flow, internal capacity building, new management systems, new levels of quality and/or innovation that may open up new revenue opportunities, direct capital investments, new market intelligence that supports product, service, and/or revenue diversification, and a path to exporting and/or expanded domestic growth.

Yet the evidence regarding the level and breadth of benefits to SMEs from GVCs worldwide is decidedly mixed. The point is well illustrated in case studies carried out by UNCTAD between 2005 and 2007 covering three industries and six developing countries.<sup>12</sup>

In the automotive industry, the researchers found extremely high levels of competition among SME suppliers along with uneven assistance from the MNCs. In South Africa, this competition took the form of imported alternatives or the relocation by the lead firm of its global suppliers/affiliates, negating prior technology agreements, and thus revenue flows from, and SME investments in, these same relationships. In Mexico, sales reliability and associated loyalty were also questionable; in the view of the MNC, the SME suppliers did not possess any specific technological or competitive advantage and were thus treated as interchangeable with other local SMEs, providing little value-added. None of the Mexican automotive suppliers was able to leverage links to GVCs as the foundation for their own internationalization.<sup>13</sup>

Findings in the software industry were more encouraging. Here, the large tech giants deployed highly structured supplier development programs for training and transfer of technology. In Egypt, a number of SMEs had graduated to serving the MNC worldwide. In Vietnam, SMEs expanded into distribution of MNC services and solutions to large domestic entities that included banks and government agencies.

Studies of suppliers in the cinema and audiovisual sector provided a glimpse into the dynamics of an emerging (even tumultuous) industry. With the proliferation of satellite and cable channels, many SMEs worldwide were able to carve out major niches in film-making and distribution. Against this backdrop, Colombian SMEs had evolved to the point where they could offer sophisticated 3-D animation for national and transnational clients in advertising, film, TV, and post-production. Work took place on a contract-by-contract basis, with only about 40 percent of firms dependent on one or two major clients. This pattern produced fierce competition from multiple countries and all sizes of firms, and the global firms made virtually no investment in training local talent.

The case studies also found the Colombian SMEs were hampered by the lack of specialized education in-country to build the skilled labor force necessary for the sector's growth. This shortage of skills appears to be a general theme for would-be and current suppliers from developing countries. High-quality human capital provides the fuel with which to forge supply relationships, develop the capacity for the effective absorption of new technology, and regularly improve production. In an investigation of 5,900 manufacturing businesses in 5 ASEAN countries, of which 70 percent were SMEs, the authors determined that workers with secondary education and well-educated CEOs (college or vocational training) both reported positive results for SME participation in GVCs, with higher levels of CEO education particularly essential for more complex operations. At the same time, an inadequately educated labor force was perceived to be a severe obstacle by 28 percent of all SMEs in the study, with percentages as high as 60 percent in select countries.<sup>14</sup>

There are also difficulties in increasing supplier relationships specific to LAC countries where the conditions for insertion based on low labor costs are absent due to high wages. Such a circumstance means that local firms cannot compete on price alone for lead firm business. Instead, firms must leverage greater skills and provide higher value-added if they are to be attractive suppliers within GVCs. An analysis based on seven Argentine sectors dominated by SMEs sheds light on this issue. This analysis used studies in diverse arenas: footwear, clothing, auto parts, light boats, wine, wood furniture, and television programming. Drawing on these experiences, the authors argue for a strategy of specialization in niche and/or differentiated goods characterized by a high degree of quality and/or customization. These types of non-mass-market products can be found in a broad number of

intensive manufacturing, medium and low technology, and service provision sectors, among others.<sup>15</sup>

Yet for SMEs in developing economies, delivering on a high degree of quality or customization typically requires an intensive capability to invest in upgrading as well as changes in managerial mindsets, fluent communications with the large customer, and a common understanding of needs. Related evidence from Argentina comparing just two of the sectors—footwear and engine valves—showed that only one of these sets of firms was able to make the necessary changes.<sup>16</sup>

### ***B. Getting in the Game: High Productivity Firms Have the Advantage***

As with exporting, internationalization by entering a GVC strongly favors larger, more productive firms. Entry into a GVC requires significant expense and commitment of resources from the start. For the lead firm, every supplier represents a potential liability. Poor standards, insufficient volume or missed deadlines at any point in the chain create the risk that the global firm will not meet its customer expectations for the finished product. Before it will accept a new supplier into the production network, a global firm must be convinced of the supplier's ability to meet stringent criteria. As a result, the typical supplier must upgrade its systems and processes well before it enters the GVC, in this way incurring a large sunk cost investment. Only the more productive domestic companies in a given sector can meet these high costs, engender trust with the lead firm and/or its strategic supplier, and enter the GVC.<sup>17</sup>

This logic has been confirmed in econometric research on 486 Czech firms. The study showed that GVC suppliers tend to be larger, more productive, exhibit a higher capital-labor ratio than their domestic-only counterparts, and pay higher wages. A fair number of suppliers were internationalized from the get-go, whether they were led by management with international connections or were directly foreign owned.<sup>18</sup> It was essential that these attributes were in place before the firms could reap additional benefits from participation within the GVC. Higher productivity equated to greater free cash flow and reflected higher levels of organizational professionalism and financial stability.

But demands for superior productivity, along with the intense competition this fosters against more advanced firms, can be a high barrier to entry for the average LAC SME. Given the learning and investment that often takes place within the GVC, the distance between the capabilities and resources

of suppliers and non-suppliers further increases over time. Moreover, government programs designed to establish and strengthen SME-GVC linkages often select larger and more stable firms deemed capable of fulfilling a long-term supplier role.<sup>19</sup>

Within LAC, some interventions have been aimed at addressing the specific challenges facing suppliers who wish to get in the game. A frequently cited success is Costa Rica Provee (CRP). CRP made information available to local SMEs on large firm purchase needs. From 2001 to 2011, CRP created 1,355 linkages and helped to increase sales for more than 400 local companies from \$800,000 to \$12 million. On the other hand, it should be noted that SMEs that joined CRP were already larger and expanding, and were often exporters themselves. Associated purchases accounted for less than 1 percent of total MNC in-country purchases in 2007, and few involved non-specialized inputs. The program's track record illustrates the need for greater resources (both budget and staff) as well as stronger coordination with related programs such as investment promotion efforts and initiatives to increase supplier access to technology and financing.<sup>20</sup>

### ***C. Benefits from GVC Participation May Differ Markedly by Tier of Supplier***

In a recent and fairly dramatic change within GVCs, fewer and fewer suppliers today may be positioned to reap the largest benefits from GVC participation when compared to the past. Since it is difficult and costly to continuously search for, evaluate, and manage supply partners, lead firms are rapidly consolidating their supplier relationship.<sup>21</sup> In so doing, they increasingly turn to tier-one global suppliers charged with organizing and interfacing with the rest of the production network. In industries as diverse as aerospace manufacturing, apparel, automotive, and retail, there are often tier-two (core) suppliers and also tier-three suppliers (base, or commodity providers) within the network.<sup>22</sup> Other industries have different configurations.

Tier-one suppliers are also known as strategic or key suppliers. They work in close alignment with the lead firm and in many locations. This proximity enables them to gain real-time information on markets, continuous investment from the lead firm in business and technology systems, and new opportunities for expansion along product, functional, and global lines. It is their job to hire, oversee, and coordinate the remaining tiers of suppliers to meet a diverse set of requirements and standards and to ensure that

lead firms receive their products and systems on time, at cost, and within specification.

This trend raises important issues for LAC SME internationalization. The first is that some benefits from GVC participation do not fully materialize when suppliers lack access to the frontier of final markets and final product specifications. It is often this type of knowledge that fuels functional and product upgrading, allowing suppliers to diversify out of a sole lead firm relationship to support other large customers or to internationalize on their own.

Second, the extent to which the strategic suppliers are able and willing to invest in tier-two and tier-three firms with capital, training, and management systems is not well known. Nor do we have a solid grasp of the degree to which internal capacity building takes place in tier-two, and especially tier-three, firms. When firms are the recipients of supplier development, they may gain new value creating capabilities which drive cost reduction, increase quality, enhance time-to-market, result in new product design, and improve environment results. These all enhance productivity and the chance to sell to new customers.

Third, it is also not clear whether the transference of the more complex and higher value-added activities to the tier-one supplier translates into reduced loyalty for suppliers at other tiers, and thus lesser reliability of revenues with concomitantly higher risk.

Clearly these issues are affected by other factors as well, for example, subsector and GVC governance. Nonetheless, the larger point for the region is straightforward: Support to accelerate SME quality participation in GVCs must be nuanced against the type and depth of benefits achievable.

Additionally, it seems that new research is needed in order to catch up with the implications of extensive consolidation by GVC lead firms. Understanding how SME suppliers at different tiers can derive maximum benefit in this new world of reconfigured GVCs is particularly relevant given that suppliers face costly and continual demands to drive down cost, improve quality, quicken delivery times, and/or reduce environmental impacts.

#### ***D. Meeting the Demands of the GVC***

While quality participation in GVCs offers many different types of LAC SMEs a high-potential route to growth, this same participation is accompanied by several unique challenges. The key issues are the following:

- **Establishing a trusted relationship.** SMEs generally lack awareness of the benefits of participation as well as knowledge of concrete GVC opportunities. Additionally, lead firms are biased towards contracting with SMEs already known to them. In the Mexican study described earlier, fully two-thirds of metal mechanics suppliers were spin-offs created by prior, long-tenured employees of the multinational; it was their existing reputation with the global firm that allowed them to initiate the contractor relationship. Access for others, while possible, is more difficult: in that same study, SMEs lacking experience with the lead firm (or without proven government or university partners) were put through a series of phases to assess credibility and responsiveness, starting with small or contingency projects and only later moving on to longer-term projects that offered the chance of becoming permanent suppliers of diversified services and goods.
- **Investing up front and without guarantees.** To meet international requirements, many SMEs must upgrade their production capabilities in advance. The cost can be quite large. In the Czech study cited earlier, for example, 40 percent of all firms with ISO certification financed this investment in advance specifically to enter the GVC. Meanwhile, 21 percent of SMEs in the study developed a tailored product for their GVC customer without GVC help in the development process. Yet the criteria lead firms use to select suppliers can be extensive, including not only product relevance, volume, and the firm's financial stability but also noneconomic indicators such as business integrity, fair employment practices and environment protection, and water usage measures. There is of course no immutable guarantee that the up-front (sunk) investment will result in GVC access.
- **Making a commitment of managerial, financial, and technology resources.** As with exporting, participation in GVCs demands per-period fixed costs in addition to the entry investment. This is a direct response to the pressures across the global production network, which are ever-increasing. Complexity arises not just from the need to move faster, reduce costs, and raise quality, but also from the internal systems, innovation, and training that must be implemented to meet these goals. Upgrading capabilities becomes a continuous process.
- **Recognizing the importance of coordination and communications.** Where contracts have failed, these are often traced to information problems within the GVC. For example, LAC SMEs may operate in

domestic environments that tolerate a far higher level of quality defects than a global firm, or that lack certification programs of global standards. In such a setting, lack of clarity regarding the specifications for quality may end the relationship. In one case, an Argentine footwear subcontractor outsourced certain manufacturing to a Brazilian supplier that was unaware of the implications of delivery delays; these delays, however, forced the Swedish lead firm to pay penalties for non-compliance to its branded marketers. When the Argentine subcontractor was terminated, so too were the Brazilian suppliers.<sup>23</sup>

- **Promoting a culture of quality.** Attaining quality standards sufficient for GVC insertion can be extremely difficult for SME suppliers accustomed to more lax expectations, whether in the initial design of an offering or in its servicing or returns. The analysis of seven Argentine sectors dominated by SMEs discussed earlier in this chapter sheds light on this factor. That analysis supports a simple but profound insight: for local suppliers to meet international quality standards as a matter of course—and not as an exception—requires fundamental changes to the management mindsets that were previously shaped in a domestic environment that was less demanding on issues of quality performance and standardization.<sup>24</sup>
- **Setting aside and/or securing sufficient working capital.** In general, small suppliers absorb their costs of production and delivery often months in advance of payment. The lead firm delays payment to suppliers until cash from its own sales is collected; this can take more than 105 days for Unilever and more than 100 days for Nestle. The onus is on the supplier to access enough working capital to survive long periods before collection from their international customers. SMEs also face a double whammy due to a practice called postponement, which is the strategy of delaying the final customization of a semi-finished good until the exact customer specification is fully known. While postponement decreases the chances of unwanted merchandise, it also shifts the burden of inventory holdings further down the supply chain, which requires even greater financial resources from suppliers.<sup>25</sup>
- **Managing dependence in the face of potentially radical change.** GVCs are pummeled by rapid change on multiple fronts. In mass-market products, consumers are demanding information on location, certifications, environmental impact, and overall traceability. In response, many agribusiness supply chains are becoming increasingly



### **Producing Quality: The Role of the Brazilian Specialty Coffee Association**

In 1984, the coffee market moved out of a commodity-only phase and into a phase of finding and monetizing new revenues from product differentiated by quality or by processes (e.g., organic). Illy, an Italian medium-sized roaster that went to Brazil attracted by the high quality of the coffee cherries in the country, quickly discovered that the problem of Brazilian low-quality coffee was mainly the lack of incentives for producers to invest in high-quality production.

Illy created an award for the best coffee beans and a price differential to reward quality, but it did not teach prospective producers the characteristics that quality coffee must have and how they can be evaluated. Some of this information could come only as the result of a great deal of practice and learning.

Some growers circumvented this market asymmetry and obtained the needed information from an intermediary, the Brazilian Specialty Coffee Association. With support of Apex, the Brazilian Trade and Investment Promotion Agency, the association developed a special classification system, a certification scheme, and a technical training program that enabled many smaller firms to learn how to identify and separate out the characteristics of a high-quality coffee. This eventually let some of the growers meet Illy's standards and join its supply chain.

*Case study synopsis in The International Fragmentation of Production: Latin America and the Caribbean in the Era of Global Value Chains. Special Report on Integration and Trade, Inter-American Development Bank, Forthcoming.*

integrated. Within manufacturing, emerging technologies such as robots and 3D printing disrupt existing patterns of production by enabling the consolidation of tasks previously executed via the coordination of separate groups and also by substituting automation for labor. This makes the SME highly or completely dependent on a small set of GVC relationships, which can translate into new sources of competition and the very real possibility that the SME's capabilities will no longer meet the requirements. For small players, radical change above all means far greater uncertainty.

## **IV. Practical Steps Forward**

This chapter has outlined the opportunity that the extraordinary growth in GVCs presents for the region's small and medium-sized firms. Integrative

solutions can enable LAC SMEs to seize opportunities at far higher levels, both quantitatively and qualitatively. Many of these initiatives could pool resources across countries, making the region as a whole that much more attractive to GVCs. Overall, coordination of mutually reinforcing programs is indispensable in order to exploit the synergies across initiatives and maximize their impact.

Priority action is needed in the following areas:

- **Strategic research.** We know a fair amount about the trajectory of Asian SME suppliers, but very little about their LAC counterparts. There is an even greater dearth of intelligence on sector-specific dynamics. An in-depth investigation is needed on key issues, such as the following: When LAC SMEs have overcome the obstacles to GVC entry, which include awareness, financing, and upgrading, precisely what did they do to be successful? When LAC SMEs do not start off as spin-offs from global firms, how do they typically discover and enter the GVC relationship? Are, for example, IP protection issues increasingly problematic, as in other regions? What are the leading MNCs' supplier selection and supplier development processes and criteria in the region? How do new trends in consolidation and the increasing role of strategic suppliers impact other tiers of suppliers? In short, what must LAC SMEs know and do in order to expand, improve, and leverage their GVC participation?
- **Raising awareness.** Few LAC SMEs beyond those that have had prior dealings with multinationals grasp the potential that GVCs represent, nor do they have the many capabilities required to access them, let alone know how to best upgrade their capabilities. Fewer still have visibility into the landscape of potential foreign partners and existing opportunities to supply them. Solutions to build awareness of benefits and process can take several forms, including direct education via EPAs and business associations, subcontracting exchanges, electronic trading platforms, and industry-specific public-private partnerships.
- **Skills development and organizational capacity building.** A dearth of sufficiently skilled workers, along with inadequate managerial systems and sophistication, plagues would-be and current LAC SME suppliers. The issues cut across company level and functions. Depending on the sector and country, they can be quite acute. The solution involves skill development, mentoring, and business development

service programs focused on the specific technical skills and business services that LAC SMEs require to partner well with global firms. Research on such capacity building reveals approaches for heightened effectiveness, such as close integration of skills development with a range of GVC insertion support and the involvement of global firms to assess and structure focus areas.<sup>26</sup> Other potential tools include establishing logistics technology centers that can facilitate the advanced use of supply management processes for many SMEs, and promoting partnerships between SMEs and universities to transfer and apply technologies, processes, and management practices.

- **Focus on compliance and quality.** Standards and certifications are a large component of the investment that SMEs must make to build and manage the GVC relationship. Given generally low-quality standards in many domestic industries, regional SMEs typically operate at a severe disadvantage. They must make more improvements before making the grade than do their competitors elsewhere. The public sector can accelerate individual firm efforts through targeted certification, labeling, and professional training programs. This can take the form of directly augmenting the national expertise in and dissemination of controls, auditing, product testing and production redesign, while assuring that national certification systems do not impose excessive burdens on SMEs. Related solutions are to support private sector implementation of quality labeling, which serves as an information signal to foreign buyers; encourage harmonized standards by global firms in their procurement procedures; and establish exchanges for collaborative information on upgrade modifications and/or for group certification where these apply to many domestic players.
- **Shared approaches to reduce individual firm sunk costs.** Much of the challenge facing SMEs lies in the need to invest in internal capabilities, coordination systems, information search, and product specifications well before achieving entry into a GVC. Initiatives to spread the cost and learning curve across many firms at once are key. This can include, for example, programs that encourage collective action and pooling of knowledge among private firms, such as through building and strengthening business associations and clusters. Programs to map out sector- and company-specific supplier selection criteria are critical; without this very targeted and detailed information, the SME

cannot upgrade its capabilities, let alone do so within the time limits often associated with the supplier selection process.

- **Structured assistance bidding for opportunities.** To bid effectively and successfully as a new supplier, LAC SMEs require access to a long list of criteria detailing the highly customized needs of a particular GVC opportunity across product specifications, delivery times, coordination logistics, costs, environmental dimensions, the firm's financial stability, and more. Even with the right information available, it can still be difficult for the SME to fully grasp and address each of these complicated issues. Public assistance can play a logical role in closing both the huge information and execution gaps involved in matchmaking. Approaches include direct matchmaking, online matchmaking and screening, support for joint bids by SME consortia, and training for SMEs to navigate and negotiate the GVC relationship. Nor would SMEs be the sole beneficiaries of such tools. Multinationals, frustrated by the slow and costly process of cultivating appropriate suppliers, can be willing to back greater information dissemination and transparency in order to deepen their pool of suppliers in a cost-effective manner.
- **Reduction in capital constraints.** Both investment capital and working capital are binding constraints for many LAC SMEs seeking to internationalize. Yet as we saw in Chapter 5, LAC SMEs face steep hurdles to access capital due to their relatively high volatility, limited track records, and inadequate financing reporting. Meanwhile, once they have entered the GVC, SME suppliers all too often face a cash flow problem: they build a product for the MNC buyer but receive payment for it only much later, sometimes well after the buyer is paid by its customer; this waiting period is often measured in months. This arrangement means they are hit doubly hard: first, by drying up of cash flow, and second, by tying up inventory. Supply chain financing (SCF) has been the focus of private sector innovations, but the kinks have not been fully eliminated. In particular, some multinationals have engaged in reverse factoring (financing the supplier's receivables in exchange for a discount) while others have engaged banks to purchase the suppliers receivables. A recent LAC example of the latter is the ProgreDir Program, launched in 2011 by Brazil's Petrobras. Public policy can help expand SCF, whether by setting up electronic platforms across GVCs, offering guarantees to banks on supplier lending, and/or in technical assistance and education to SMEs.

- **Support to diversify relationships.** Dynamic change across the supply chain introduces tremendous uncertainty. A key risk occurs when a lead firm shrinks its presence or pulls back entirely; this can rapidly negate the prior investment of SME suppliers and eliminate what were once large and steady revenue sources. At the country level, without this central relationship, the public sector investment may be lost, while the local economy is in the same place—or even worse off. One way to address this issue is to facilitate information flows across the GVC and its tiers of suppliers, especially concerning the multinational's product road map and envisioned production requirements. Another solution is to help SMEs recognize, protect, and extract the value of the intellectual assets and property that they develop as suppliers, thus maximizing their return on investment and expanding their future opportunities. Capacity building is also a strategy to counteract dependency risk in that it equips SMEs to support more than one large customer, diversify product and service offerings, deepen their knowledge of local drivers for product development, and increase organizational flexibility.
- **Repository of best practices.** Insertion of LAC SMEs into GVCs is just the start of this internationalization trajectory; its benefits lie in continuing, and enhancing, quality participation and relationships. These benefits can be truly transformative for SMEs—when the odds are stacked in their favor. Yet today, the individual firm is routinely required to reinvent the wheel. Changing this paradigm requires collating best practices on the GVC-SME linkage, communicating the insights in ways that LAC SMEs can use them, and enabling regional companies to build upon one another's experiences as suppliers. SMEs would find answers to such questions as: What are the best practices in my sector or location? How can I adopt these principles in new settings? How can pitfalls be averted with advance knowledge and planning? In short, such an information repository would equip LAC SMEs to capitalize on the region's hard-won lessons in growth through GVC participation.

It should be emphasized that success requires close coordination among programs that address the range of challenges and market failures that hinder SMEs in accessing and gaining strong benefit from supplier networks. Put another way, attacking all relevant dimensions of the problem

is often the only way to get the most from the resources spent on any one intervention and avoid suboptimal outcomes. Such coordination includes support for capacity building, management coaching, access to technology, absorption of innovation, availability of financing, as well as the general diffusion of knowledge and business practices new to the local environment. Facilitating the involvement of the private sector via public-private partnerships and collaborations is also essential.

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- 12 United Nations Conference on Trade and Development (2010). *Integrating Developing Countries’ SMEs into Global Value Chains*. United Nations.
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- 17 There appear to be sector-specific exceptions to this rule, when multinational firms cannot find a sufficient number of suppliers and are thus willing to make investments into the supplier’s business at the start of the relationship. Some cases exist in agribusiness (and particularly organics). Yet again, the selection criteria favor larger, more professionalized and/or more productive firms. Further, once the investment has been made, it serves as a further barrier to non-suppliers.
- 18 Javorcik and Spatareanu (2004) “Tough Love: Do Czech Suppliers Learn from their Relationships with Multinationals?” Rutgers University, Newark Working paper #2009-004. Similar conclusions arise from work on Chilean suppliers that are also foreign affiliates in *The International Fragmentation of Production: Latin America and the Caribbean in the Era of Global Value Chains*. Special Report on Integration and Trade, Inter-American Development Bank, forthcoming.
- 19 For example, Costa Rica Provee described in the next bullet point.
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- 24 Gonzalez and Hallak, “Internacionalización de PyMes argentinas orientadas a segmentos no masivos del mercado en países desarrollados,” working paper 2013. For related insights on this issue, please see the section on trade standards in Chapter 3 of this report.
- 25 Ibid.
- 26 *The International Fragmentation of Production: Latin America and the Caribbean in the Era of Global Value Chains*. Special Report on Integration and Trade, Inter-American Development Bank, forthcoming.



# Leveraging the US Hispanic Diaspora to Drive LAC SME Exports



## I. A Targeted Strategy

In this chapter, we set forth an innovative and potentially transformative strategy for LAC SME internationalization: the organization and targeting of a meaningful portion of the region's export promotion resources, activities, and provision of information specifically on LAC SME export initiatives directed at the US Hispanic Diaspora market.<sup>1</sup>

The US Hispanic Diaspora represents a significant—even unprecedented—opportunity for the region's small and medium-sized firms. According to Nielsen Company, the global marketing analytics giant, if the US Hispanic market were a stand-alone country, its buying power would make it one of the top 20 economies in the world. US Hispanic buying power reached \$1 trillion in 2010; by 2015, it will be \$1.5 trillion, an increase of 50 percent in five years, some of them within a recession.<sup>2</sup> This buying power is equivalent to Australia's entire economy and 30 percent larger than that of Mexico. Per capita income of US Hispanics is higher than in three of the four BRIC countries of Brazil, Russia, India, and China.<sup>3</sup>

Nor is the opportunity confined to engaging the consumer. Forbes reports that the US recovery is being spearheaded by Latino and Latina business owners. These businesses are growing at twice the US national average.<sup>4</sup> There are roughly 3.2 million Hispanic-owned companies in the US small business sector alone,<sup>5</sup> generating over \$500 billion in revenue, and creating robust prospects for supplier, outsourcing, and partnership relationships.<sup>6</sup>

LAC SMEs that win the business of US Hispanics are positioned to gain a foothold into the world's largest economy (and LAC's key trading partner) through a segment of pivotal importance to the US future. In fact, in several sectors, succeeding in the US over the coming decades may well depend upon capturing the loyalty of US Hispanics. This is the fastest growing and youngest ethnic segment in the US—and by a wide margin. While Hispanics already accounted for half of US growth from 2001 to 2011, they will constitute the majority of US growth going forward. US Hispanics are expected to grow 167 percent from 2010 to 2050. This compares to 42 percent for the total population, 56 percent for blacks, 142 percent for Asians, and a mere

1 percent for white non-Hispanics. Meanwhile, in a country that is aging swiftly, 75 percent of US Hispanics are under the age of 45. The median age of the US Latino population is 28, nearly 10 years younger than the total market median, making it a primary driver of new consumption.

Beyond its phenomenal size and broader influence, the Diaspora is a particular match for LAC SMEs, and for at least four reasons:

- First, cultural relevancy matters a great deal to US Hispanics. US Hispanics expect the companies with which they do business to address their unique preferences, use culturally appropriate messaging, understand their diversity, and care about their community. The vast majority exhibit high levels of cultural pride and a commitment to the Spanish language that span generations.
- Second, US Hispanics as a group maintain distinctive purchasing patterns, technology usage, and media consumption that set them apart from the rest of the market. These patterns, along with very large established bases in a handful of US states and cities, make it possible for companies to create, market, and customize offerings to the needs of the Diaspora.
- Third, the US Hispanic community is racially and ethnically diverse. This fact opens opportunities for regional SMEs to target subsegments by such characteristics as country-of-origin, immigrant versus American-born, economic tier, and/or educational status. Moreover, the region's firms are likely more able to understand the associated subtleties and be able to capitalize on them than are many non-Hispanic SMEs, whether US-based or from other world regions.
- Fourth, the timing appears to be right. Despite a concerted effort by global firms to reach the US Hispanic consumer, many product categories (and many more potential innovations) remain up for grabs. It is still relatively early in the race to seize not just immediate purchasing dollars but also a long-term and trusted position as a favored business, brand, and/or supplier. In the words of one market observer, the US Hispanic community is one of the greatest untapped markets ever seen.<sup>7</sup>

Together, these facts fuel the concept presented in this chapter: with public support, LAC SMEs can leverage the US Hispanic Diaspora for sustainable export success. Such an approach might also provide a focal point

and thus accelerated momentum for collaborative regional export initiatives. To generate strong gains in SME internationalization, it very likely requires a multistep roadmap, including appropriate support mechanisms and integrated policy solutions. This chapter is designed to stimulate discussion of the strategy, first by exploring high-level benefits and challenges, and next, by outlining several elements of an action plan to move the strategy forward.

## **II. Impact on Critical Constraints to LAC SME Internationalization**

The US Diaspora strategy would reduce bottlenecks that constrain LAC SMEs from exporting.

### ***Key Benefits from the Diaspora Relationship***

A major benefit accrues from a decrease in information barriers. As discussed in Section II of this report, lack of information creates a two-way barrier to exporting. Without a strong product or country brand in place, buyers may assume a neutral or negative perception of company quality and product attributes. At the same time the small exporter is faced with a huge search process to gather and assess data on markets and trade partners.

The fact that US Hispanics overwhelmingly feel a general cultural affinity, while also prioritizing the Spanish language, creates a halo effect that can greatly reduce the typical reputation constraints. Meanwhile, these market characteristics would also make it far easier for LAC SMEs to build a constructive and trustworthy dialog with potential channel partners than with non-Hispanic partners in other markets. More generally, studies of Diaspora business networks worldwide reveal that Diaspora relationships can be a powerful enabler of, and shortcut to, essential and reliable information for exporting, and especially for differentiated goods. For example, within the well-known Chinese and Indian Diasporas, related communities of business people have acted as trusted agents and helped match exporting firms with strategic partners.

Another key benefit concerns sunk costs that are not information based.<sup>8</sup> Recall that the inability to “sink” export investments stops many would-be SME exporters in their tracks, and/or forces SMEs to adopt an ad hoc or on-again-off-again exporting pattern that is often incompatible with achieving permanent and reliable export growth; this is especially true given that sunk costs can be quite large relative to SME free cash flows and capital resources.

For some LAC SMEs, the ability to rely predominantly on Spanish in marketing, customer service and/or maintenance would minimize this entry constraint. To put this in perspective, extensive research shows a strong, shared connection to the Spanish language that cuts across all Hispanic segments—by economic tier, immigrant status, country-of-origin or age. For example, a 2011 survey carried out by the Pew Research Center reports that 74 percent of Hispanics age five and older speak Spanish at home; 82 percent of Latino adults say they speak Spanish; and fully 95 percent of Hispanic adults say it is important for future generations to continue to do so.<sup>9</sup>

### ***Additional Benefits Due to Location***

This Diaspora community's location in the US puts three additional factors in play.

First, for some LAC countries, geographic proximity would make it simpler to glean market intelligence and travel to the destination to vet partners and set up systems, which would reduce both information-based and non-information-based sunk costs.

Second, in many cases, selling into the US Diaspora brings with it many of the same advantages in reduced trade costs that LAC companies experience in selling to the US overall. US border administration is transparent, relatively free of corruption, and predictable, unlike in many developing markets. For destinations that are relatively nearby, transportation and transport services are usually less costly and cumbersome.

Third, there is the opportunity to leverage preferential treatment under trade agreements struck between the US and LAC countries. These RTAs reduce policy barriers to trade while giving LAC SMEs an edge vis-à-vis competitors from countries that do not have trade deals with the US.

### ***Constraints to Internationalization that Could Increase Under This Strategy***

The strategy is not without its challenges, however, and could constrain SME internationalization in two ways.

The first of these constraints are demands on intra-firm capabilities. The US market demands highly sophisticated products that are frequently upgraded in terms of specifications and design (consumer sector) and/or are acutely customized (business sector). These market dynamics put pressure on SMEs to develop and sustain advanced internal capabilities in terms of planning, product adaptation, technology/innovation, and their integration.

Second, there will likely be high and perhaps multiple standards of trade compliance to navigate. Numerous sectors in the US require compliance with stringent public and private sector standards, putting time and cost pressures on the SME exporter. Similarly, while the rules to conform with and qualify for free trade agreements may be transparent, it is tough to play by them all.

### *Opportunities for Future Expansion*

Clearly, penetrating a very large and fast growing market brings with it the potential for expansion within the same market for years to come. As certain LAC SMEs become established players within the US Hispanic Diaspora, they may find they don't have to enter other regions and markets in order to grow, thus avoiding many of the new entry costs that can be involved with subsequent export expansion. Learning plays a key role as well. In areas as diverse as product localization and channel bonding, many SMEs should be able to leverage and upgrade the same set of internal levers that lead to earlier market successes, rather than developing entirely fresh capabilities.

It should also be noted that LAC SMEs that operate successfully within the US Hispanic Diaspora, may gain a toehold in US markets overall. Such a scenario is not a foregone conclusion. Among US businesses (both large and small), competition for the US Hispanic dollar is intense, and heating up. That the market is hot should be viewed as both a blessing and a curse. On the one hand, stiff competition raises the bar on intelligence gathering, marketing, and product adaptation requirements in the SME's search to identify and build offerings that serve a differentiated market need. On the other hand, it sets the stage for LAC SMEs to shine by empowering US Hispanics via cultural and linguistic resonance and relevance. Further, a sustained presence in the US can open access to the world's deepest financial markets, thus removing capital as a binding constraint on internationalization.

Moreover, the market's demand for quality and its level of competition means that selling into the US Hispanic market can, over time, dramatically enhance an SME's credibility and reputation in the US as a whole. In what might become an important externality as some LAC SMEs build a reputation for quality and relevance within the US, this perceptual benefit could be extended to other firms in the region, whether new entrants or those with smaller market positions.

### Nicaragua's Small-Scale Dairy Producers Sell to the US Market

Nicaragua's Boaco dairy cluster was created when Salvadoran entrepreneurs came to that country to purchase milk for processing and to export to their home market.<sup>a</sup> Their objective was to capitalize on Nicaragua's comparative advantage to produce cheese for export to other Central American markets as well as the growing Salvadoran Diaspora in the United States.<sup>b</sup> The entrepreneurs brought with them an in-depth knowledge of the Salvadoran consumer market as well as the techniques for making the *morolique* cheese popular among Salvadorans.<sup>c</sup>

The role of the Salvadoran investors in Boaco parallels that of Parmalat, an Italian active in Nicaragua's dairy industry, albeit on a much smaller scale. Parmalat is a major global dairy producer, which invested in Nicaragua in 1998–99 to gain a foothold in the Central American market as a whole.<sup>d</sup> As with its investments elsewhere in the world, Parmalat's investment in Nicaragua was aimed at consolidating and rationalizing fragmented fluid milk production under its brand name.<sup>e</sup> As a result of the investment, the firm upgraded and expanded milk processing in its Nicaraguan facilities.<sup>f</sup> The Italian firm now purchases some 25 percent of the milk sold through commercial markets in Nicaragua. Parmalat's ultimate goal is to use Nicaragua as a platform to expand sales of its dairy products throughout Central America.<sup>g</sup>

Hoping to seize an opportunity on a smaller scale created by the Salvadoran investors, about 20 very small craft cheese producers in Boaco, Nicaragua, formed a cooperative called *Cooperativa de Quesos Cantores*.<sup>h</sup> In order to succeed, they recognized the need to achieve the scale required to meet export market demand as well as to upgrade their production process and satisfy quality standards demanded by consumers.<sup>i</sup>

The cooperative's formation had an immediate impact. By adopting a common purchasing plan for significant inputs in the production process, the producers took advantage of the greater scale the cooperative offered and lowered their production costs by 10 percent.<sup>j</sup> Those cost reductions allowed the cooperative to begin selling profitably to the Salvadorans, who exported the cooperative's cheese to El Salvador.

In addition, the cooperative turned to the Salvadoran firms for the first private investments in upgrading their production process.<sup>k</sup> As is true of SMEs in the dairy industry in Nicaragua generally, the cooperative and other producers had good technical capacity in traditional methods, but they lacked an understanding of the composition and properties of milk, as well as skills-related quality assurance procedures and standards.<sup>l</sup>

Through their investments, the Salvadoran firms transformed production processes throughout the Boaco cluster, including the hiring of chemists and food technologists to control the quality of raw and processed milk.<sup>m</sup> For the cooperative, those investments, combined with financial and technical support from other sources, including the Nicaraguan government and various nongovernmental organizations, enabled it to construct a new processing facility, improve water filtration, and establish a small laboratory to help control the milk's alkali balance and limit contaminants.<sup>n</sup>

As a result, the cooperative improved the quality of its product, which had an immediate impact by increasing production and sales by an additional 10 percent in its first

three years of operation.<sup>o</sup> Profits from those sales enabled the cooperative to open its own retail operation in Boaco.<sup>p</sup>

The diffusion of technology and learning generated by the Salvadoran investments proved especially critical to Cooperativa de Cantores when El Salvador blocked exports of unpasteurized Nicaraguan cheese to that country's market in July 2009.<sup>q</sup> A crisis was averted by an agreement between Nicaragua and El Salvador that provided for inspections of Nicaraguan production facilities to ensure that they met Salvadoran health standards. The cooperative, which had upgraded its production processes, quickly resumed exporting to the Salvadoran market.

The development of the cooperative's export potential, as well as that of the Boaco dairy cluster generally, also benefited from the region's proximity to a large local market in Managua.<sup>r</sup> Expanded sales in their home market offered additional scale that allowed them to compete in export markets as well. The link to Managua also ensured relatively good transportation infrastructure needed to bring perishable products to market.

The export capabilities of Boaco's dairy cluster also benefited from foreign assistance programs and Nicaraguan government support.<sup>s</sup> In one such initiative that particularly contributed to the cluster's eventual export success, the Finnish-supported PRODEGA program helped introduce a culture of quality in production of dairy products that proved instrumental in regaining and expanding export market access in the Salvadoran market and beyond.<sup>t</sup>

The cooperative's next step was to establish a link to the diaspora in the US. The Salvadoran, Honduran, and Nicaraguan residents of the US represent an estimated market of 2.5 to 3 million, or about one percent of the total US population, which constitutes a large potential market for the cooperative.<sup>u</sup>

The efforts of the cooperative and other Boaco producers to tap that market were aided by an important policy intervention: the negotiation of the free trade agreement between the United States, five Central American states, and the Dominican Republic in 2004 (CAFTA-DR). This agreement did more than lower entry barriers. Before CAFTA-DR, dairy exports from Nicaragua did not meet the sanitary standards required by the US Food and Drug Administration (FDA).<sup>v</sup> CAFTA-DR served as an umbrella under which the US provided assistance to the Nicaraguan producers, such as training in good dairy sanitation procedures at the farm and good manufacturing practices, including the implementation of Dairy HACCP (Hazard Analysis and Critical Control Points) and pasteurization at the Nicaraguan processing plants.<sup>w</sup>

The FDA assistance resulted in an increase in the number of Nicaraguan plants certified for export to the US from three to sixteen.<sup>x</sup> The net effect was a doubling of Nicaraguan dairy exports to the US in the three years following the implementation of the technical assistance program. From 2006 to 2009, Nicaraguan exports to the US increased from \$ 4.7 million to \$ 9.6 million.<sup>y</sup>

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### Nicaragua's Small-Scale Dairy Producers Sell to the US Market *(continued)*

From the cooperative's perspective, the key to tapping the US market is distribution through neighborhood bodegas or small supermarkets specializing in Central American products for diaspora consumers. The morolique hard cheese that the cooperative produces is a favorite among those retailers—as well as their customers—due to its long, four-to-six-month shelf life. The cooperative's products already find their way to the US market through those distribution channels, but, as yet, only via Salvadoran middlemen. The challenge ahead lies in marketing through those channels directly under the cooperative's own name.

a. And per-period fixed costs that are not information based.

b. <http://www.pewhispanic.org/2012/04/04/when-labels-dont-fit-hispanics-and-their-views-of-identity/> accessed December 29, 2013.

c. Zuñiga-Arias, G., *El Desarrollo de Cadenas de Valor Agroindustriales en Costa Rica, El Salvador y Nicaragua. El Caso de Estudio de la Agroindustria Láctea*, CEPAL Serie Estudios y Perspectivas, no. 126 (2011); Pietrobelli, C., *Global Value Chains and Clusters in LDCs: What Prospects for Upgrading and Technological Capabilities* (2007).

d. Pietrobelli, C., and R. Rabellotti, *Upgrading in Clusters and Value Chains in Latin America – The Role of Policies*, Inter-American Development Bank (2004).

e. *Ibid.*

f. Artola, N., and M. D. Parrilli, *The Development of the Dairy Cluster in Boaco and Chontales, Nicaragua* in Pietrobelli, C., and R. Rabellotti (eds.), "Upgrading to Compete Global Value Chains, Clusters, and SMEs in Latin America" ("Dairy Cluster in Boaco") (2006).

g. *Ibid.*

h. *Ibid.*

i. *Ibid.*

j. United Nations Industrial Development Organization, *Proyecto "Fortalecimiento y difusión de conglomerados en Nicaragua" - RED: COOPERATIVA DE SERVICIOS MULTIPLES DE QUESOS CANTORES R. L. BOACO, NICARAGUA* ("Quesos Cantores").

k. *Ibid.*

l. *Ibid.*

m. See RUTA, Nicaragua - *Motores de Crecimiento Sostenible y Reducción de la Pobreza del Conglomerado Lácteo de la Región Central Sur* (2007) ("Motores de Crecimiento").

n. Perez-Aleman, P., *Collective Learning in Global Diffusion: Spreading Quality Standards in a Developing Country Cluster* ("Collective Learning") (2011).

o. Coon, J., A. Campion, and M. Wenner, *Financing Agriculture Value Chains in Central America*, Inter-American Development Bank (2010).

p. Dairy Cluster in Boaco.

q. Foro Centroamericano Estrategias de Asociatividad par alas MIPYMES, Presentation – Red: Cooperative de Servicios Multipler Quesos de Cantores R. L., Boaco, Nicaragua.

r. *Ibid.*

s. Collective Learning.

t. Motores de Crecimiento.

u. Quesos Cantores.

v. Pietrobelli, C., and R. Rabellotti, *Upgrading in Clusters and Value Chains in Latin America – The Role of Policies*, Inter-American Development Bank (2004); Eskola, E., *Rural Development Cooperation - Learning from Finland's International Projects and Programmes* (2003).

w. Batres-Marquez, S. P., H. Jensen, and G. Brester, *Salvadoran Consumption of Ethnic Foods in the United States* (2001).

x. U.S. Agency for International Development, *Exports of Dairy Products to the United States Under CAFTA-DR – Impact Brief*.

y. *Ibid.*



### *From Theory to Action*

We next look at what might be required to translate this strategic vision into concrete action and impact. This discussion is not comprehensive, but rather seeks to present several ways to move the strategy forward.

## **III. Practical Steps Moving Forward**

At the core of this strategy lies the shared action needed for development of critical relationships, promotion, information, and financing in order to advance LAC SME exports to the US Hispanic Diaspora. In anticipation of a more detailed design phase, we have identified several priorities for an integrated roadmap. They include the following seven components:

- Creating and leveraging influential Diaspora relationships.
- Further targeting export promotion activities.
- Developing an in-depth repository of information.
- Focusing on key sectors.
- Identifying high-potential marketing strategies.
- Marketing the region as a source of quality exports.
- Helping LAC SMEs pursue tailored financing opportunities.

### **A. Creating and Leveraging Influential Diaspora Relationships**

#### **1. Proliferation in Diaspora Organizations Organized by the Public Sector**

Many attempts have been made to organize Diaspora communities in an effort to spur their members to participate in home country development. These attempts have taken many forms, including measures to spur entrepreneurship, foster international trade flows and direct investment, sell bonds, and even outright philanthropy. Countries as diverse as South Africa and Sri Lanka have created purposeful Diaspora alliances. In the region, Colombia has worked to inspire scientific sharing, while Latin America and the Caribbean have each launched regional business plan competitions. To support Diaspora networking as a tool for global development, former Secretary of State Hillary Clinton in 2011 launched IdEA, a partnership linking the US Department of State, the US Agency for International Development, and the Migration Policy Institute.

In LAC, the systematic engagement of US Diaspora relationships to help SMEs find trustworthy trade partners, cement these buyer and channel contacts, and guide ongoing market penetration, would be a major step forward in galvanizing LAC SME internationalization.

### **Scotland's GlobalScot Program: A Model for Building and Promoting Successful Diaspora Networks**

Successful Diaspora networks are characterized by at least two attributes: they engage influential and highly skilled expatriate professionals, and they jump-start and magnify the role of Diasporas in helping home country firms to identify overseas opportunities and connect them to buyers, distributors, and other key relationships. Additionally, strong Diaspora networks often lead to direct involvement and investment in home country projects by network members.

When the business knowledge, financial resources, and intrinsic motivations of expatriate communities combine to accelerate trade and development, outcomes can be truly remarkable, as the experiences of China and India demonstrate. In most cases, however, networks do not spring up spontaneously, but rather, can be organized and leveraged by public institutions. The track record of such public programs is mixed, whether due to design, or budget, or length of commitment. Scotland's GlobalScot program is a pioneering example of a government-sponsored network that has achieved exceptional and long-term results. Hence there is much to learn from the GlobalScot approach.

After a six-month research phase, GlobalScot was established in July 2001 for an initial three-year period. This pilot period was designed for learning and course correction. Three interrelated objectives were established in building an international network: contribute to Scotland's economic success, mobilize network members to support Scottish economic activity, and maximize opportunities emerging from the network's relationships, knowledge, and expertise.

It is important to note that while GlobalScot marketing clearly emphasizes its goals of helping Scottish businesses to access new markets and to connect them to the world, from the start it had an agenda broader than fostering exports and foreign direct investment. As such, GlobalScot encompasses major value generation on trade in the form of opportunity identification, market entry advice, business and investment introductions, and negotiations assistance, while at the same time supporting Scottish entrepreneurship and innovation, including business mentoring, global research initiatives, and student placements in overseas internships. This broader objective has resonated with Scottish expatriates and affiliates, who have answered the call in accordance with their differing professional interests and ambitions. Consequently, GlobalScot has inspired a virtuous cycle that directly addresses the twin market failures of information flow and relationship deficiencies. As discussed throughout this report, it is these market failures which especially impede SME internationalization.

The launch of the program followed on the heels of Scotland's 1997 reestablishment of its independent parliament. The government began to reposition Scotland as a knowledge economy, and accordingly, prioritized a very wide range of differentiated sectors. These sectors, with the related mission to mobilize global knowledge to help strengthen the Scottish economy, became focal points for the network.

From the start, GlobalScot established forward momentum by undertaking a variety of measures. At its launch, 450 invitations were sent to a carefully selected group of influential

people worldwide, including senior executives in foremost business firms. In just three months, 300 people in 40 countries had accepted. This 75 percent acceptance rate has continued throughout the program's existence and program membership has more than doubled. Engagement has been similarly high, with about 70 percent of those contacted responding. A majority of members have offered to help. Contributions per year consistently number in the hundreds. Meanwhile, GlobalScot sponsors over 60 member events per annum, such as a 2009 global conference that attracted more than 100 GlobalScots and resulted in new business leads for 70 percent of members attending and 60 percent of participating Scottish firms.

In 2011, at its tenth anniversary review, GlobalScot reported that member efforts through the network had helped generate a total of over £30 million of gross value-added for Scotland.

Factors leading to this success include the following:

**Placing relationships front and center.** The invitation to the founding members came directly from Scotland's First Minister, with one-on-one follow-up by senior staff to solicit members' views on their potential contributions and desired levels and means of engagement. Members are welcomed into the network on the website and some are subsequently recognized through case studies and profiles.

**Presenting a persuasive value proposition.** Whether in print, online, or in person, the organization's mission has been articulated in consistent, straightforward, and emotionally resonant ways. Similarly, as credibility built over the early years, the program published success stories in order to stimulate demand and participation by domestic businesses.

**Valuing ongoing reciprocity to members.** Along with business value that may accrue to them from working with Scottish firms, GlobalScots benefit from inclusion in a specialist community with worldwide reach. They receive access to elite biographies, directories, discussion forums, and a variety of international gatherings.

**Appropriately resourcing and structuring the support organization.** GlobalScot is managed by the International Networks team within Scottish Enterprise, working in collaboration with Scottish Development International, other government agencies, and private partners. In 2005, GlobalScot's annual budget stood at £300,000.

**Engendering ownership by members and participating companies.** The organization empowers members and companies so that a government facilitator is not needed to broker each relationship and idea. GlobalScot is the platform from which members and companies generate new solutions, and not as the solutions provider.

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### Scotland's GlobalScot Program: A Model for Building and Promoting Successful Diaspora Networks *(continued)*

**Thoughtfully choosing key metrics.** It is said that what gets measured gets improved. GlobalScot monitors not only final outcomes in terms of numbers of relationships consummated and overall deal value, but also key performance indicators tracking infrastructure, capacity, member engagement, and perceptions of relationship quality.

In 2007, GlobalScot began to mentor networks of expatriate talent in several middle-income countries through learning programs conducted by the World Bank Institute, advising others how to harness the talents of their Diasporas to help pave the way for internationalization.

*Sources:* Macrae, Marie with Wight, Martin, "A Model Diaspora Network: The Origin and Evolution of GlobalScot" and Kuznetsov, Yevgeny, "Leveraging Diasporas of Talent: Toward a New Policy Agenda" in *Diaspora Networks and the International Migration of Skills*, ed. Kuznetsov, Yevgeny (2006) WBI Development Studies; "The Global Role Model – GlobalScot's Interview with YevgenyKuznetsov" on the World Bank website, accessed 16 December 2013; 2011 GlobalScot Annual Review "GlobalScot: Building an International Business Network for Scotland – 10 Years of Networking Success, 2001–2011."

Government-supported programs have achieved very different degrees of success according to the strength of organizational resources and their ability to constructively incentivize the participation of Diaspora leaders. The box below on the "GlobalScot" program illuminates several success drivers, among them, the importance of constructing and articulating a defining value proposition, the centrality of giving back to Diaspora leaders, and the role of relationship management and continuous improvement.

#### **2. Findings from Diaspora Relationships Orchestrated by Diaspora Leaders**

We will now examine what is likely the preeminent example of an influential US Diaspora community and how it has created its own formal organizations. The US Indian Diaspora is the essential player in the build-out of India's IT and related sectors. The US Indian Diaspora is part of the more than 20 million people of Indian origin who live in 70 countries worldwide, generating the equivalent of two-thirds the GDP of India. The 1.7 million Indians living in the US are particularly prominent. As of 2004, 200,000 Indian families in the US were headed by millionaires, while 44 percent of those who were born in India occupied professional or managerial positions, or were prominent academics and researchers.<sup>10</sup>

Throughout their emigrant history, Indians have maintained a strong cultural connection to their homeland, including a tradition of mentoring and strong community involvement. Two sets of formal organizations

encouraged US Indians to build on this legacy. One is comprised of the alumni of the prestigious Indian Institutes of Technology. Another, established in 1992, was The Indus Entrepreneurs, a Silicon Valley-based network through which experienced Indians mentor others.

Given its remarkable business impact on the internationalization of India's firms, including many SMEs, the US Indian case can function as a model for any formal Diaspora network. US Indian executives, acting as brand ambassadors, were willing to put their own careers on the line by advocating for Indian SMEs when the sector and firms they were mentoring were still unproven. They were subsequently willing and able to provide capacity building for their Indian vendors. Lead members of this Diaspora did not nurture relationships with Indian firms solely because of cultural affinity; they viewed these opportunities, and their unique ability to navigate them, as extremely valuable to their own careers.

These lessons point to a powerful mechanism for galvanizing LAC SME exports. A US Hispanic Diaspora organization would serve as a search network, matching LAC SMEs to business partners and opportunities, boosting the region's reputation among potential US trade partners, and helping the region's firms understand and commit to overall criteria for success. Such a network would identify prominent US Hispanics in a range of leadership roles, inviting and structuring their contribution to the region's development and connecting leaders to one another for further gain. This network would catalyze the cultural pride, optimism, and vitality that exists in the US Hispanic community.

### ***B. Further Targeting Export Promotion Activities on the US Hispanic Diaspora***

Export promotion agencies are continually faced with the need to trigger impact with limited resources. The second element in this roadmap would create a focal point for prioritizing a meaningful portion of LAC country investment in US-focused trade initiatives and export promotion in order to accelerate LAC SME exports into the US Hispanic Diaspora.

In this scenario, one objective of the region's participation in trade shows, sponsored trade missions, and business matchmaking (among other activities) would be to highlight LAC SME offerings and abilities and the needs and preferences of the US Hispanic Diaspora. This would be augmented with outreach to major US Hispanic business associations; preliminary examples include the US Hispanic Chamber of Commerce and the

Latino Coalition. There are also many industry- and state-specific associations, as well as consulting and marketing agencies dedicated to helping businesses sell to US Hispanics.

The region's export promotion organizations can be leveraged in part to educate SMEs on the huge opportunity this market presents—along with tactics and requirements for penetration and uptake.

### ***C. Developing an In-Depth Repository of Information***

As we have seen throughout this report, exporting is information intensive. Because assisting LAC SMEs to leverage the US Hispanic Diaspora involves one country as well as submarkets with common themes and dynamics, it is possible to lower the information barrier in carrying out this strategy.

One important element in this strategy would be the development of a detailed and user-friendly regional information portal for LAC firms and their intermediaries on the factors essential to exporting to the US Hispanic Diaspora. This high-impact regional public good would eliminate the need for individual LAC SMEs to separately identify, collect, and analyze critical issues. A shared regionwide repository may also reduce work that must be performed by individual export promotion entities. The repository would help to address the information gap that affects regional SMEs regardless of country-of-origin, through a collective information facility. The repository would translate, catalogue, and simplify information on topics that include customs and trade compliance, transportation and logistics, customer profiles, market demand data, industry dynamics, and marketing strategies. Over time, the portal would become both increasingly robust and streamlined as usage patterns are observed, and as proprietary sources of information (including the business associations and consultants) are nurtured.

### ***D. Honing In on Key Sectors***

While some marketers believe that the US Hispanic community is underserved across industries, certain product and service offerings have a higher likelihood for export success in the US Diaspora. The key is to identify these sectors and match them to the supply side in order to focus resources and help LAC SMEs pursue the US Hispanic market.

According to Nielsen and IBISWorld, both well-regarded producers of industry research reports, seven economic sectors are expected to benefit most from the US Hispanic demographic change. These sectors are residential buying, food, retail clothing and electronics, higher education and

technical schools, financial services, automotive and air transportation, and entertainment and media. Increased consumption in many of these sectors spawns a range of other needs. For example, while LAC SMEs are likely not involved in primary home purchases and goods needed to renovate, maintain, furnish, and decorate residences, they will nevertheless benefit, as evidenced at a 2012 first-ever Expo for US Hispanic home buyers. On the business-to-business side, the outsourcing of Spanish-language services—for example, Spanish-language call centers, software support, and training—as well as medical tourism may have high potential.

Sometimes, the market opportunity is premised on an ethnic (emotional) connection, for example in categories such as food, clothing, and accessories. To provide insight on leveraging the ethnic dimension, the penetration and expansion of Pollo Campero fast-casual restaurants in the US is detailed in the Box below.

In general, a “deep-dive” market identification process would pinpoint additional, high-demand and underserved opportunities. Analytically, it is possible to work backwards from granular profiles of major US Hispanic consumer segments and map these against a supply-side view of relevant LAC SME sectors, offerings, and specialties. For example, US Hispanics outpace all Americans in mobile data consumption, with US Hispanic youth consuming mobile and cross-platform media, including full-length music and video downloads, at even higher rates. Many examples bear out this market potential. For example, in 2012, US Hispanic youth spent \$17.6 billion on mobile devices and more than \$500 million on mobile apps. They lead all whites and African-Americans in use of mobile phones to access the Internet and in text messaging.<sup>11</sup> Yet at the same time, there is a dearth of Spanish-language entertainment and other content specific to interests of US Hispanics, and especially considering the high demand. These gaps may open up opportunities for LAC SME television/film/sports producers and advertisers, along with SMEs with mobile development and digital media software expertise.

## **E. Identifying High Potential Marketing Strategies**

### **1. A Segment That Lends Itself to Targeted Marketing**

Providing relevant perspective on marketing would be important in educating SMEs about the US Diaspora as an export market. We have previously discussed the strong emphasis on Spanish-language content among US Hispanics (including those who are bilingual). This connection, along

### **Guatemala's Pollo Campero: A Strong Latin Brand Leverages Cultural Connection to Thrive in the US Diaspora**

Starting out with one store in Guatemala City in 1971, the restaurant chain Pollo Campero (“country chicken”) had grown to \$400 million in revenues and more than a dozen countries worldwide by 2009. Its foray outside of the LAC region was jump-started with a single, highly successful franchise in Los Angeles, California, in 2002. Its annual growth rate in the US in the period 2002–2007 was a spectacular 25–40 percent. By 2010, the company had restaurants in more than 50 locations across the nation. In that same year, the company reported per-unit sales averaging \$1.7 million annually—nearly double that of well-established quick-service and fast food rival, KFC.

Serving up its fresh home-style cooking, regional spice mixes, brightly colored décor, and family-friendly atmosphere to an avid and preexisting fan base of largely Central American immigrants, the firm provided a product that reminded people of home.

Another lesson of value to other SMEs is how this midsized firm has been able to expand within markets of similar consumer characteristics through skillful management and an ongoing commitment to internationalization and learning-by-doing.

Pollo Campero's first major expansion outside of Guatemala, and a few sites in El Salvador, took place in the 1990s with a move to Honduras. As in the first two countries, the brand resonated with locals as a place one could take mom on Mother's Day. Learning from a failed 1986 attempt to gain a foothold in the US through an owner-operated restaurant in Miami, Florida, the company's family management then selected a new business model for internationalization: franchising. Franchising would allow the firm to utilize its deep knowledge and hands-on leadership of in-country players, and to shift its revenue sources from operating profits to management and marketing fees. The franchising program grew rapidly across Panama, Nicaragua, Costa Rica, Ecuador, and Mexico, leading to a total of 143 sites in less than a decade. Management also set about standardizing its operational processes to support its numerous franchisees and assure a consistent brand and customer experience.

Pollo Campero might have been content to remain a regional star. But market signals strongly urged otherwise. Airline carriers approached the company with an unexpected request. It seemed that US-bound passengers embarking in Guatemala City and San Salvador were stocking up on Pollo Campero food items at their airport branches—sometimes even intended for resale in the US! The aircrafts on these routes smelled of chicken, and Pollo Campero was asked to use scent-proof packaging. Management considered the request an indicator of potentially high demand; a subsequent research effort revealed large brand recognition in major US cities. Growth within the US would bring with it economic and currency diversification, along with new revenues. Highly experienced restaurant operator Adir was selected as the first US franchisee, and in 2002, a store opened in Los Angeles, home to the largest concentration of Guatemalans outside of Guatemala City. Even in the face of intense US market competition, the store set a record out of the gate, hitting \$1 million in revenues in the first three weeks and generating extensive media coverage.



Pollo Campero continued to expand, especially to cities with a high concentration of Latin Americans, such as Chicago, Washington DC, New York, Dallas, San Antonio, and Houston. In 2007, emphasizing again the importance of learning-by-doing, management decided to stop running the business from half a continent away and established a US headquarters in Dallas. They hired Guatemalan and US executives, with the US leaders shoring up what had been (for the US market) substandard marketing and operations functions. They also hired a well-known global consultancy and a top advertising agency to help reshape future strategy.

Unlike many LAC SMEs, this medium-sized firm is a subsidiary of a multibillion dollar conglomerate active in several food- and trade-related sectors. The relationship with the parent has likely led to sourcing and financing advantages that may not otherwise have been possible. Still, it remains to be seen whether Pollo Campero will be able to expand significantly further within the US. As of 2007, estimates placed total ethnic food purchases in the US at roughly \$75 billion, with some 75 percent of this amount generated by nonethnic consumers. Accordingly, the company has signed partnerships with veteran restaurateurs in a possible bid to regain its early US growth rates. As example, Lawrence Levy, whose firm runs food concessions in more than 70 major sports and entertainment arenas, has opened several Pollo Campero franchises, including one that replaced a McDonald's in Walt Disney World's entertainment district near Orlando in 2010 and serves an average of 20,000 customers per week. At the same time, however, a highly publicized pilot relationship with Walmart failed, with in-store locations closing in their first few years. Similarly, publicly stated goals to open 500 units in the US by 2012 have clearly missed the mark, and by a wide margin. This is not to imply current difficulties with the existing US franchises and revenues. Rather, the challenge is to reach beyond the core Central American customer, where the company's competitiveness remains to be tested.

Regardless, the company has leveraged its US experience to great advantage on the world stage. In 2000, the firm expanded to Madrid, Spain, via a strategic alliance with an experienced domestic player. It was also the first Latin American restaurant group to enter Asia, beginning in Jakarta, Indonesia, in 2007, and it has since established a presence in the Middle East. Pollo Campero's knowledge of franchise management, along with a sensitivity to local customization needs, have enabled it to expand to more than 300 restaurant outlets, including in such countries beyond the Americas as Italy, India, and Bahrain. As is often the case with internationalization, by virtue of both internal (management) learning and external (market) credibility, success has begotten success.

*Sources:* "Pollo Campero: A Guatemalan Chicken Flying Across Global Borders" pp. 152–162 in *From Multilatins to Global Latinas: The New Latin American Multinationals* (Compilation of case studies) (2008) IDB Vice Presidency for Sectors and Knowledge, Integration and Trade Sector, Office of Outreach and Partnerships European Office; Pollo Campero website, accessed December 16–17 2013; Brene, with Montoya C and Chattopadhyay, "Pollo Campero in the United States" (2012) INCAE Business School; Michael Arndt, "At Pollo Campero, Growth Is on the Menu," *Bloomberg Business Week* March 11, 2010.

with heavy media and geographic concentration, makes it possible for many of the region's SMEs to effectively target their marketing and sales efforts.

Language profoundly influences an advertiser's ability to connect with US Hispanics. This single fact could be a game changer for LAC SMEs. Recent research by Nielsen found that while Hispanics remember English-language commercials as well as the general population, when the same commercial is shown in Spanish, it bumps up ad recall by as much as 30 percent. When Spanish native-speakers deliver the ad script, recall increases another 30 percent. US Hispanics respond to ads 51 percent more if viewed in Spanish rather than English.

Meanwhile, the Hispanic community lends itself to a localized marketing approach in building export sales, including local retail presence, local media buys, grassroots word-of-mouth, and so on. Even as the Hispanic population spreads to states not traditionally known for their Hispanic presence, the market remains highly concentrated by geography. According to the National Council of La Raza (NCLR), the largest national Hispanic civil rights and advocacy organization in the US, 47 percent of the US Hispanic population lived in California or Texas in 2010; California was home to more than 14 million Hispanics, and Texas to more than 9.4 million. Fourteen other states have at least half a million Hispanic residents, as does Puerto Rico.

On the media side, while marquee television and cable providers dominate Spanish language programming as well as the most popular English-language programming, LAC SMEs can take advantage of the US Hispanic love for social media. Both mega websites and social networking sites are frequented extensively, from Facebook, LinkedIn, and Twitter, to the more targeted Terra – Telefonica, Univision Digital Network, and Yahoo en Espanol.

Niche media offerings are springing up with increasing frequency, a development that is important to LAC SMEs and often more cost-effective for advertisers. Further, the Diaspora's tendency to use smartphones to access the Internet along with their heavy reliance on mobile media and joint family viewing of television, all suggest that customized and focused marketing strategies can be highly effective in winning purchase dollars and customer loyalty.

Other feasible marketing approaches would leverage corporate partnerships with Diaspora businesses to jointly reach an end market (for example, by providing a "bolt-on" product or service to the existing offering) as well as direct service to Diaspora businesses. On this point, the number of Hispanic-owned businesses is rising dramatically. According to NCLR,

Hispanic businesses grew by 44 percent from 2002 to 2007, compared to 15 percent growth in the number of firms owned by non-Hispanics. Hispanics own more than 29,000 firms with receipts of \$1 million or more. Key sectors are retail trade, construction, and wholesale trade, which account for just over 50 percent of Hispanic-owned business receipts.

## ***2. Accounting for Perceived Identity***

Marketing campaigns and product targeting must take into account both similarities and differences within the market in such factors as country-of-origin, immigrant versus American-born, economic status, and educational status. For example, the US Hispanic market is ethnically and racially diverse. In 2009, the Latino population on the US mainland was composed of Mexican Americans (65 percent), Puerto Ricans (9 percent), Cubans (3.5 percent), with the remainder made up of Central Americans, South Americans, and people of other Hispanic or Latino origins (more than 21 percent). Despite different national origins, certain similarities bind these communities together. Widely shared views and values include the priority placed on family ties and family time, a belief in hard work, and pride in the Hispanic legacy. Moreover, on a range of economic and moral issues, either a majority or a plurality of US Hispanics see life in the US as an improvement over life in the country of origin.<sup>12</sup>

It is also critical to note that most US Hispanics view their identity through the lens of their family's country of origin, and not in pan-ethnic terms. In fact, when it comes to identity, just over one-half of all US Hispanics prefer to use their ancestral country to describe themselves, while about one-fifth use the term "American" and about one-quarter prefer "Latino" or "Hispanic."<sup>13</sup> These subtleties open up two likely avenues of response. On the one hand, firms can play up a connection to Hispanics that hail from their country as relevant to their product offering and brand. The other path is to avoid the specifics of country of origin and appeal instead to common language use and cultural markers.

## ***F. Marketing the Region as a Source of Quality Export Offerings***

Lack of reputation and brand name can severely impede sales by SMEs from emerging markets whose countries of origin may not be well known for their offerings in non-commodity sectors. Many of the countries in the region have established a premier trade promotion presence in the US, with numerous offices, active services, and brand building for various forms of

cross-border investment and business, including but not limited to GVCs and FDI. It is a logical element of this strategy to leverage, increase, and integrate institutional mechanisms in order to market the region as a source of valuable export offerings within key sectors.

To increase the impact, this action area would include collaboration with organizations that bring relevant expertise and relationships and a common incentive. Among these organizations are US Hispanic business and networking organizations, industry- and geographic-specific alliances, US Hispanic consumer groups and advocates, consultants, and marketing firms, as well as prominent US Hispanic figures and the Diaspora network discussed earlier.

### ***G. Helping LAC SMEs Tap Tailored Financing Opportunities***

LAC SMEs currently face a severe crunch in financing their export operations, as we have shown in Section II. The US Hispanic Diaspora strategy may open up previously unavailable sources of funding, at least for medium-sized exporters once they have established US Diaspora sales and are seeking to grow further.

For example, some US private equity players are now targeting a portion of their investments on businesses that serve the US Diaspora market. These include Palladium Equity Partners, with over \$1.4 billion in assets, and Acon Equity, an international fund that also finances Latin American deals. Both are leading investors with deep experience with companies that target Diaspora segments.

In what might be signs of a growing trend, billionaire investor Ron Burkle and his Yucaipa Companies announced in 2011 that they would launch a new partnership to back companies targeting the large and growing Hispanic community in the US, including firms that have Hispanic management teams, are targeting the Hispanic market, or are Central and South American companies looking to enter the US.<sup>14</sup>

There may also be an opportunity to develop new financing facilities that could pool monies from the Diaspora and use them to accelerate LAC SME Diaspora exports. This would extend benefits to smaller LAC SMEs that require relatively small amounts of capital to gain traction in the US Diaspora market. The idea stems from the fact that financial transfers between the Diaspora and a home country are not new. For example, some local governments in the region have pooled remittances from the Diaspora to fund infrastructure improvements, typically at the same small

scale envisioned here. As with all the tactics outlined in this chapter, this concept would require planning, evaluation, and testing to shape its specific design.

#### **IV. Conclusion**

This chapter has outlined the opportunity presented by the size, youth, and growth of the US Hispanic Diaspora for the region's small- and medium-sized exporters and would-be exporters in both the consumer and business sectors. SMEs from any other world region would be hard-pressed to serve this market. The Diaspora's linguistic and cultural preferences, along with its distinctive purchasing, technology, and media patterns, make this opportunity especially potent for LAC SMEs.

We outlined a number of benefits for the region in pursuing a large-scale and integrated approach to stewarding LAC SME exports into the US Hispanic Diaspora. Foremost among these are a sharp decrease in information barriers and other sunk entry costs that limit SME exports. By virtue of the US location, for many companies this strategy would result in relatively lower trade costs compared to other destinations. The benefits of building out within a huge and growing market are also relevant. On the other hand, major challenges include stringent demands on intra-firm capabilities and high standards of compliance, often from multiple actors.

Overall, it appears that the timing is excellent. Competition (while intense) has just begun to heat up, the landscape for partnerships is still greenfield, and it is relatively early in the race for niche positions and loyalty in many product categories.

In order to realize the strategy's transformative impacts, we have proposed that the region develop a systematic roadmap to identify, structure, and integrate essential components of the solution. While a design-and-stakeholding phase is clearly a requisite next step, we began this discussion with a description of seven action areas to consider as part of such a strategy. These include such activities as engaging influential relationships within the Diaspora to accelerate LAC SME internationalization, developing an in-depth repository of information, and helping LAC SME exporters access new financing options specifically available primarily to those with US presence. Throughout, successful execution depends on the tight coordination of initiatives, rigorous evaluation and pilot testing, and well-managed public-private partnerships.

One of the reasons that the Chinese and Indian Diasporas have been crucial in boosting development in their home countries has been their critical mass. Similarly, it is likely that the strategy to penetrate and engage the US Hispanic Diaspora in support of LAC SME internationalization would benefit from a regional pooling of efforts.

## Endnotes

- 1 This potential policy solution focuses exclusively on the US Hispanic Diaspora due to its phenomenal size and growth rate, and defining characteristics. In rough terms, about one in ten people who identify as Hispanic lives in the US. At the same time, some of the discussion in this chapter may be applicable to export support to help regional SMEs target other Hispanic Diaspora markets.
- 2 Nielsen (second quarter 2012). “State of the Hispanic Consumer: The Hispanic Market Imperative.”
- 3 Ibid, with reference to Goldman Sachs Global Economics, Commodities & Strategy Research: BRICS Monthly Issue June 24, 2011. Hispanic per capita income is from Census in 2009 constant dollars. Hispanic per capita income is second to Russia, and above that of Brazil, China and India.
- 4 As reported by the Center for Hispanic Leadership.
- 5 The Huffington Post reporting on data from the Center US Hispanic Chamber of Commerce and Geoscape. “Number of Hispanic-Owned Businesses nearly Doubled Over the Last Decade,” September 13, 2013.
- 6 Center for Hispanic Leadership (2012). “Unlocking the Hispanic ‘Super Consumer’ Opportunity.”
- 7 Ibid.
- 8 Ibid.
- 9 Ibid.
- 10 Pandey et al. (2006). “The Indian Diaspora: A Unique Case?” pp. 71–78 *Diaspora Networks and the International Migration of Skills*. World Bank Institute.
- 11 Ramos, K. (July 15, 2012). “Uber-connected young Latinos spend billions on mobile, says new study.” <http://nbclatino.com/category/people>.
- 12 <http://www.pewhispanic.org/2012/04/04/when-labels-dont-fit-hispanics-and-their-views-of-identity/> accessed December 29, 2013.
- 13 Ibid.
- 14 The Wall Street Journal online blog, October 27, 2011. “Yucaipa Launches New Partnership To Target US Hispanics.”





# The Online Opportunity: Helping LAC SMEs Leverage Cross-Border E-Commerce<sup>1</sup>

## 9

One of the most powerful ways for LAC SMEs to reach global markets is through e-commerce. A global survey of small companies reveals that 95 percent that sell on eBay also export on eBay—that is seven times more than the 13.4 percent of LAC firms that export in general.<sup>2</sup> What is more, 60–80 percent of companies that export over the Internet survive in the export markets, as opposed to 30–50 percent of overall, traditional exporters. This is an opportunity for LAC SMEs. Compared with much of the developing world, Latin American SMEs are rather well connected to the web. But the region’s companies have yet to take full advantage of the Internet’s full potential for internationalization in terms of identifying foreign markets and customers, marketing products and services to overseas customers, and making the sale online. This can change. The purpose of this chapter is to show how.

The first part of the chapter discusses the market opportunity that the Internet offers. The second part elaborates on policies to help Latin American SMEs to participate in cross-border e-commerce.

### I. Opportunity to Tap 5 Billion Global Consumers

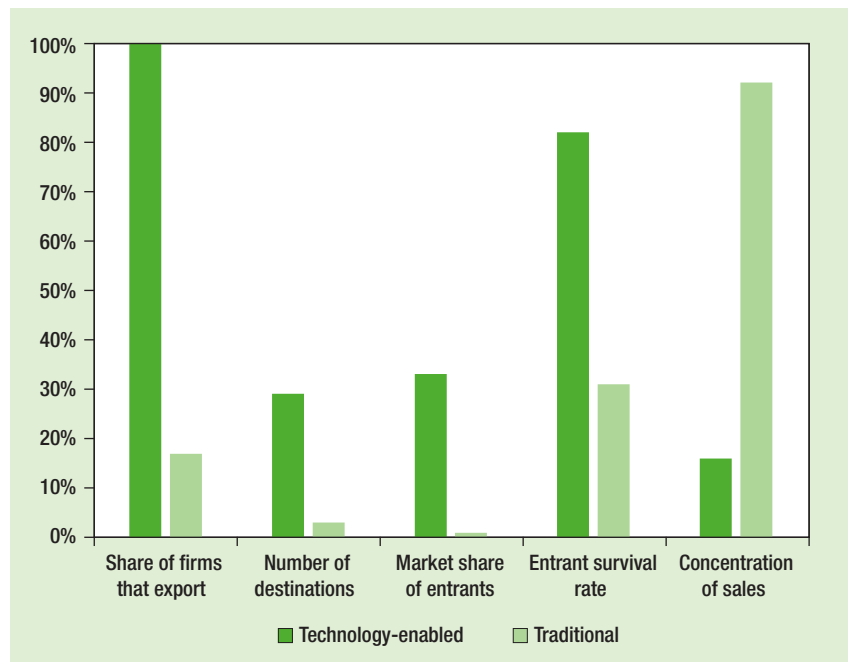
Online trade is in many ways easier than the traditional, offline trade, and it can critically accelerate SMEs’ internationalization. Used strategically to explore export markets, the Internet reduces search costs involved in trade, i.e., the costs for companies to locate foreign customers, analyze competition, identify sources of trade finance, and so on. As such, online trade helps companies leapfrog geographical barriers and reach potential suppliers and customers around the world. In addition, by using the web, companies can engage in passive exporting: sellers do not necessarily need to attend trade missions, trade fairs and networking events, travel overseas, or make calls to score global customers. They can simply post their goods online and serendipitously get approached by foreign buyers, even from the most distant markets.

Online trade can also reduce buyers’ search costs. For example, a Korean wine importer looking for South American wines will be able to screen and compare wineries online and order samples before, or even without,

paying a visit to the other side of the Pacific. A recent analysis of eBay-based online transactions shows that online trade also helps build trust among buyers and sellers by helping buyers disentangle the exporter's quality and reliability from the exporter's country image.<sup>3</sup> In other words, the buyer can make the purchasing decision based on information about the exporter's reliability and reputation, rather than having to rely on the exporter's country image for information. As such, the web can help reduce the relevance of geographic, institutional, and cultural distances among firms in different countries.

These notions can be demonstrated empirically. While online and offline exporters may not be immediately comparable, firms in such countries as Peru and Chile that use online tools to trade are much more likely to export, diversify, and survive in the export game than companies trading in the traditional, offline fashion. For example, in Chile, all commercial sellers on eBay export, and on average these firms sell to 28 different markets. A full 80 percent of entrants survive after the first year, well above the third for traditional sellers (Figure 1). Exporter concentration is also much less in online trade than offline trade: entrants that sell on eBay make up 30 percent of

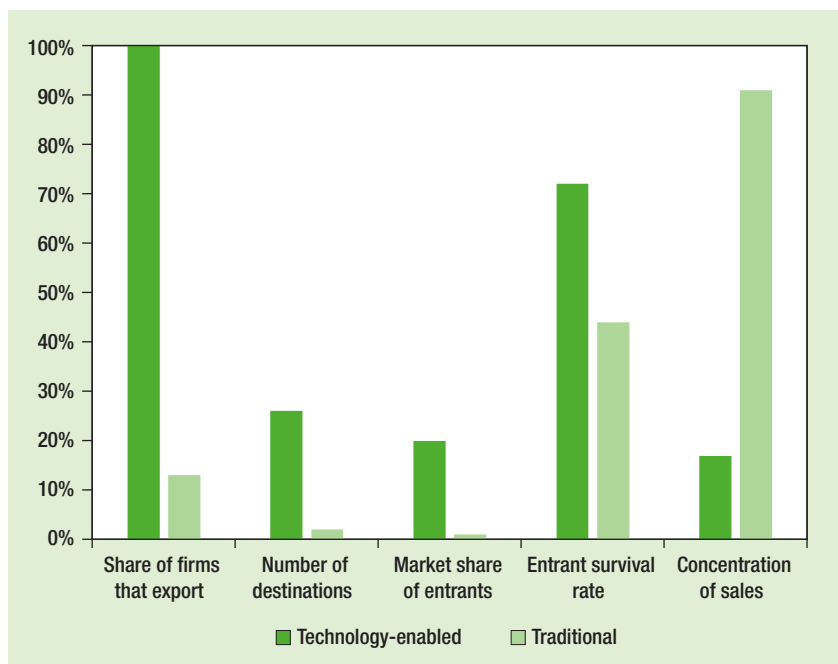
**FIGURE 1/**  
Export Participation  
and Performance of  
Chilean Technology-  
Enabled vs. Traditional  
SMEs, 2013



Source: eBay (2013). Commerce 3.0 for Development.

Chile's overall e-commerce export sales, as opposed to entrants that export through traditional means, which make up only 1 percent of Chilean exports. The concentration of sales into the top 5 percent of firms is also very limited at only 16 percent, as opposed to 92 percent for Chile's traditional exports. The setting is very similar in Peru (Figure 2).

Using the web not only facilitates selling and buying across borders; it can also streamline doing business. Consider customer service. When customers have access to their own personal accounts online, they do not need to call, which saves time and money for all parties. Using the web can also facilitate payments: SME suppliers that can issue e-invoices to corporate customers generally have greater visibility in the payment process and quicker access to confirmations than do paper-based firms. SMEs that use the web can also search for capital providers and participate in supply chain financing offered by a corporate buyer. Finally, online services can help to do the work of a sales team, an accounting team, a market research team, a tax team, a marketing team, and a customer services team. In other words, using the Internet is not only good for internationalization; it also can help make LAC companies become more efficient and competitive.



**FIGURE 2/**  
Export Participation  
and Performance of  
Peruvian Technology-  
Enabled vs. Traditional  
SMEs, 2013

Source: eBay (2013). Commerce 3.0 for Development.

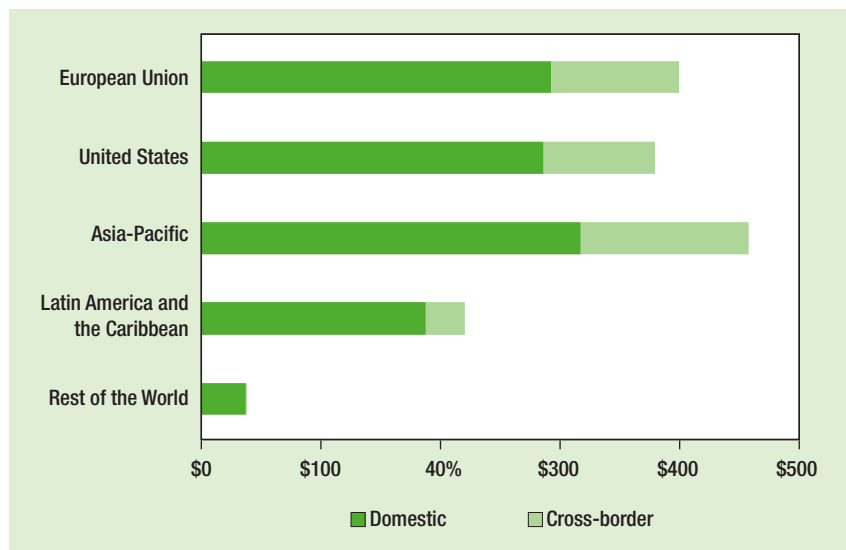
### A. Expanding Market

The market for LAC SMEs that sell online is poised to expand dramatically. Already, some 2.6 billion people, or 38 percent of the world's population, use the web, and by 2022 an estimated additional 2–3 billion people will access the web, typically through smartphones, particularly in China, India, and Africa, but also in Brazil (where 50 percent of the population is online) and throughout South America. Cross-border e-commerce still accounts for only about 16 percent of all e-commerce transactions around the world, but it is growing rapidly. By 2017, cross-border e-commerce will make up 20–40 percent of all e-commerce in the EU, the US, and Asia Pacific (Figure 3).<sup>4</sup>

The growth of cross-border e-commerce will be especially explosive in Asia Pacific: that region's cross-border online trade will grow 3.7 times between 2011 and 2017 to \$140 billion. For Latin America, cross-border e-commerce is projected to grow from \$10 billion to \$32 billion between 2011 and 2017, when it will account for about 15 percent of total e-commerce transactions carried out in the region. Brazil will account for almost 60 percent of the LAC e-commerce market, followed by Mexico and the Caribbean.

That five billion people will be online within a decade opens up a vast new market for Latin American SMEs, whether they are selling to foreign companies or to consumers. Indeed, while most cross-border online trade is still of the business-to-business variety—B2B transactions comprised 90

**FIGURE 3/**  
Domestic and Cross-Border E-Commerce Marketplace in 2017 (in millions of US\$), by Country/Region



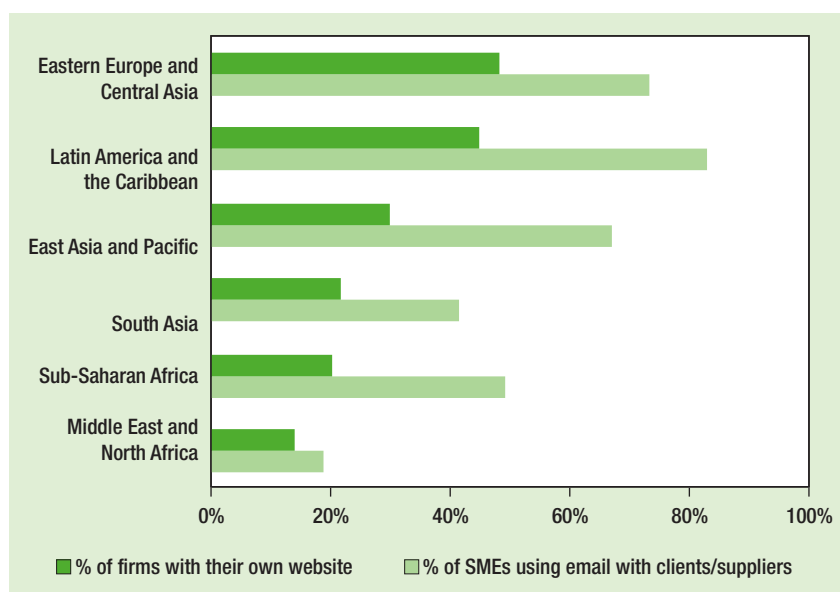
Source: Forrester and ChannelAdvisor.

percent, or \$12.4 trillion, of all e-commerce in 2012 and about a tenth of that is cross-border—online transactions will be increasingly consumer driven, as B2C and C2C e-commerce continue expanding. Latin America’s own intra-regional e-commerce consumer market is growing very rapidly (See Box below).

### B. LAC SMEs Are Well Placed to Leverage the Web

LAC SMEs appear well placed to both take advantage of the expansion of global and intra-regional online markets. According to Enterprise Survey data, some 45 percent of LAC SMEs reported having a website, and as many as 83 percent of surveyed LAC SMEs use email for the same purpose—well above the emerging world averages of 34 and 64 percent, respectively (Figure 4). According to some estimates, almost all larger LAC SMEs (firms with more than 100 employees), both exporters and current non-exporters, use email to communicate with customers and suppliers.<sup>5</sup>

Given the relatively high levels of Internet use, cross-border e-commerce ought to be a low-hanging fruit opportunity for LAC SMEs that seek to internationalize. Yet it is not fully leveraged: even though many companies use email and have access to the web, the majority still do not have their own websites, let alone capabilities for potential buyers to order online.<sup>6</sup> This appears to be a lost opportunity, particularly in light of the expansion of online



**FIGURE 4/**  
Percent of SMEs with  
Their Own Website and  
Using Email, 2006–2010

Source: Enterprise Surveys.

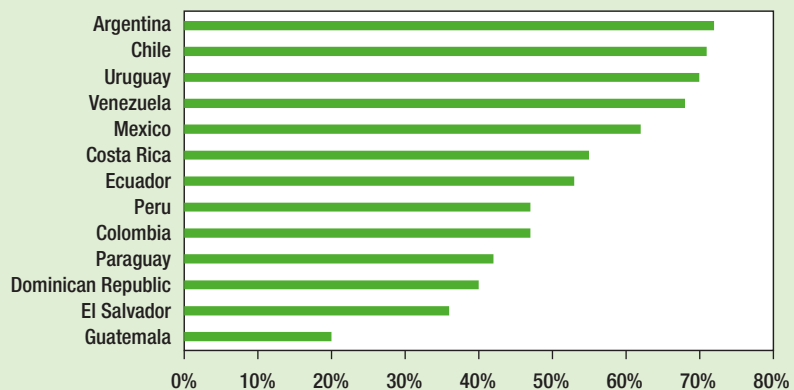
### The Expanding Market of Latin American Online Shoppers

The rapidly expanding intra-regional consumer market opens major opportunities for LAC SMEs seeking to expand their sales not only at home, but also in other markets in the region. Each week eight out of 10 Latin Americans search and research products online. Many also make online purchases. A survey of 18,000 online shoppers in 13 countries shows that in such countries as Argentina, Chile, Uruguay, and Mexico, some 60–70 percent of web users buy online (Figure 1). The web is also enticing Latin Americans to buy more. A 2011 survey of 3,500 online shoppers from Peru, the Dominican Republic, Puerto Rico, Costa Rica, Panama, Ecuador, Colombia, and Chile shows that six out of ten shoppers first become interested in a product after finding it online and the same percentage said they ended up buying a product after finding it on the web.<sup>a</sup>

The online opportunity will only grow, given Latin Americans' hunger for mobile phones; about a quarter of Latin Americans make online purchases with smartphones. In 2011–12, four of the world's ten fastest growing iOS and Android markets, as measured by the number of active devices, were Chile (279 percent), Brazil (220 percent), Argentina (217 percent), and Mexico (193 percent).<sup>b</sup> Latin Americans are using their smartphones in various parts of the e-commerce process. For example, 60 percent use them to take photos of products, 56 percent to send text messages to family or friends about products, and 42 percent to look for nearby stores.<sup>c</sup> Some 40 percent read comments about products from other consumers, 39 percent use their smartphones to compare prices, and 34 percent click on mobile ads.

Latin America's online shoppers also spend a good deal of money on their Internet purchases. In a recent survey, some 75 percent of online consumers in Argentina, 73 percent in Venezuela, and 66 percent in Brazil were most likely to spend \$100–1,000 on Internet purchases in a period of three months.<sup>d</sup> Fourteen percent of Brazilians and 17

**FIGURE 1/** Percent of Internet Users Who Bought Goods and Services Online in 2011



Source: Tendencias Digitales survey of 18,000 consumers.

percent of Venezuelans spent more than \$1,000. Other countries in the region report similar levels of online spending, including Chile (76 percent), Colombia (69 percent), Mexico (78 percent), and Peru (78 percent). Majorities of these buyers in Chile, Argentina, Colombia, Mexico, and Peru spent \$100–250 online in the past three months.

Most purchases made by LAC online shoppers are non-durables: 43 percent of Latin American online consumers buy clothes and 41 percent buy electronics, 36 percent buy music or movies, and 35 percent buy appliances. A third purchase computer hardware online, and 31 percent buy tickets to shows and events and apps. These findings echo international patterns. In a recent survey of 6,000 online shoppers in the US, UK, Australia, Germany, China, and Brazil found that clothing, shoes, and accessories represent the largest cross-border online shopping category in five out of the six markets, with Brazilian shoppers opting for computer hardware.<sup>e</sup> Overall, the top cross-border online shopping categories are clothing, shoes, and accessories (\$12.5 billion); health and beauty (\$7.6 billion); personal electronics (\$6 billion); computer hardware (\$6 billion); jewelry, gems, and watches (\$5.8 billion); and home electronics (\$5.4 billion).

Latin American online shoppers shop globally when shopping online. Estimates vary, but it is estimated that up to 75 percent of Latin American shoppers find the products they search online on international, typically US e-commerce sites.<sup>f</sup> For example, while 55 percent of Latin Americans buy on MercadoLibre (eBay's Latin American partner site), only 23 percent buy on Garbarino, an Argentine e-commerce site. Brazilian online consumers buy the most from e-commerce site Americanas at 27 percent, while in Chile the top local e-commerce site is Falabella, with 41 percent purchase rate. MercadoLibre overall appears to be the market leader among Latin American shoppers. For example, although over a half of Latin American online consumers visit Amazon, only 22 percent buy on it, and while over a third visit Wal-Mart, only 10 percent buy on it.<sup>g</sup>

<sup>a</sup> Lendle, A., M. Olarreaga, S. Schropp, and P.-L. Vezina. 2012. "There Goes Gravity: How eBay Reduces Trade Costs," World Bank Policy Research Working Paper 6253 (October) < <http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-6253>>. See also Lendle, A. and M. Olarreaga, 2014. "Can Online Markets Make Trade More Inclusive?" Mimeo, Inter-American Development Bank (January).

<sup>b</sup> See Kent Allen, "Brazil and Beyond: Exploring Ecommerce Opportunities in Latin America," Pitney Bowles, 11 October 2012 < <http://blogs.pb.com/ecommerce/2012/10/11/brazil-and-beyond-exploring-ecommerce-opportunities-in-latin-america>>.

<sup>c</sup> See D'alessio Irol and Google 2011. "Estudio Ropo." (June). See summary on Bruno Almeida, "8 Insights about E-Commerce in Latin America," Latin Link, December 13, 2012.

<sup>d</sup> Kent Allen. 2013. "E-Commerce: Easing Cross-Border E-Commerce," *Americas Quarterly* (Summer).

<sup>e</sup> comScore webinar, "2013 Latin America Digital Future in Focus," May 29, 2013 < [http://www.comscore.com/Insights/Presentations\\_and\\_Whitepapers/2013/2013\\_Latin\\_America\\_Digital\\_Future\\_in\\_Focus](http://www.comscore.com/Insights/Presentations_and_Whitepapers/2013/2013_Latin_America_Digital_Future_in_Focus)>.

<sup>f</sup> comScore webinar, "2013 Latin America Digital Future in Focus," May 29, 2013 < [http://www.comscore.com/Insights/Presentations\\_and\\_Whitepapers/2013/2013\\_Latin\\_America\\_Digital\\_Future\\_in\\_Focus](http://www.comscore.com/Insights/Presentations_and_Whitepapers/2013/2013_Latin_America_Digital_Future_in_Focus)>.

<sup>g</sup> Nielsen, 2013. *Modern Spice Routes: The Cultural Impact and Economic Opportunity of Cross-Border Shopping*. Seven out of ten online shoppers in the survey are mid-to-high income earners, and the majority are between 35 to 54 years old. The average age is younger in emerging markets – in Brazil, 25 to 44 years, and in China, less than 30 years.

commerce: successful internationalization is increasingly synonymous with successful web presence and engagement in e-commerce.<sup>7</sup>

## II. How to Help LAC SMES Leverage the Web

The LAC region will likely see its share of digital entrepreneurs in the coming years who will succeed at leveraging the e-commerce opportunities. Also several LAC companies will probably end up exporting unintentionally, merely by being discovered by foreign buyers after displaying their products on the web. However, broad-based engagement of LAC companies in the global digital economy requires policies that accelerate especially the LAC SMEs' use of the Internet. There are three distinct areas for policy interventions:

### A. Convert Non-User SMEs into Users

The most immediate way to enhance LAC SMEs' use of the Internet for internationalization is to convert non-users of the web into users. Though quite connected, Latin America can still do much more to advance the spread of the web. Most Latin Americans are still not using the web, and most SMEs are not making the most of the Internet. As such, Internet adoption is important and will require further investments, including in broadband access, computerization, and e-learning.

By the beginning of 2013, the majority of LAC economies had a national plan, strategy, or policy already in place to promote broadband.<sup>8</sup> But more work remains to be done, both to include the 12 countries without a national broadband plan, connect the entire populations to the web, and encourage the adoption of the Internet, which will require ICT skill development, digital literacy and e-learning programs, and general awareness building. For example, a recent study in Colombia found that a large majority of the country's SMEs did not understand how broadband access could help their business.<sup>9</sup> There are also extensive opportunities for public-private partnerships with corporations in the network, communications technologies, and cloud computing. For example, in India, Intel and the Indian government have partnered for a national digital literacy initiative.

Spreading the web not only fuels online trade; it generates public goods in such areas as education, healthcare, energy conservation, and government transparency. Growth can follow: a recent study finds that every 10 percent increase in broadband penetration corresponds to a 1.38 percent increase in economic growth in low- and middle-income countries.<sup>10</sup> The gains are even



more pronounced in LAC, where a 10 percent rise in the market penetration of broadband services is associated with a 3.2 percent average increase in GDP and a 2.6 percent increase in productivity.<sup>11</sup>

### ***B. Teach SMEs to Leverage the Web for Cross-border Transactions***

LAC SMEs require e-commerce-related awareness and capacity building in order to best use the Internet and mobile technologies in their businesses, including for export operations. While it has many advantages over offline trade, online trade is not simple. It requires capabilities to research and locate foreign customers and markets over the web; develop a web-based marketing strategy involving social media, e-commerce platforms, and search engine optimization; brand, label, and price products for foreign customer tastes; translate websites into foreign languages; create a multichannel shopper strategy; and establish partnerships with local e-commerce platforms such as Taobao in China or MercadoLibre for Central and South America. There also needs to be a savvy advertisement strategy; this can be relatively low cost, as illustrated in the Box below that describes the Mexican small business Urmex.

Selling online does not exempt companies from the usual challenges in trade covered in this report, such as trade compliance, customs regulations, product standards, shipping and logistics, and so on. This means that LAC's export promotion agencies will need dedicated strategies for guiding SMEs to engage in online commerce.

There are also opportunities for public-private partnerships aimed at increasing SME exports through such means as e-commerce platforms, shipping and logistics companies, and credit card issuers. One of the recent examples is El Salvador's PROESA (Agencia de Promoción de Exportaciones e Inversiones de El Salvador), which in October 2013 launched a program to support SMEs' online trade.<sup>12</sup> The Online Export Program is aimed at 90 companies with export potential, and consists of five modules of classroom training to boost these companies' technical capacities to use virtual tools such as social media and digital marketing for advertising and marketing their products or services, and to help them plan an overseas marketing strategy by using the Internet.

### ***C. Reduce Barriers to SMEs' Online Business***

The third way to catalyze cross-border online trade is by addressing the special challenges of SMEs that already use the web for exporting online. Some

### Starting with 100 Pesos, Selling Online across Latin America

The expansion of Internet usage in Latin America has enabled local companies to reach new customers across the region. One example is Urmex, a small business with 10 employees in Toluca, Mexico. Urmex produces and distributes USB drives, iPhone holders, and other accessories that incorporate the client's logo or favorite picture or feature. The products are used as gifts and promotional items by businesses and individuals.

Established in 2005, Urmex initially promoted its products with physical flyers and cold calls. To test traction in the online marketplace, Urmex decided to invest 100 pesos (less than \$10 dollars) in online advertising to reach customers in Mexico City. Realizing an immediate return on investment, the company invested in further online campaigns across Mexico.<sup>a</sup> Succeeding again, Urmex invested in advertising throughout Latin America and prepared to sell online. Among other tools, the company uses Google AdWords that enables it to display ads in specific parts of the world, advertises with YouTube videos and Twitter, and sells products on such e-commerce platforms as MercadoLibre and Alibaba. The company also has country-specific sites and Twitter feeds, such as a dedicated site for Colombian customers.

In 2011, the company tripled its profits after its ad campaign gained traction in Latin American export markets. By 2012, 60 percent of Urmex's profits were generated by regional exports to Argentina, Chile, Colombia, Costa Rica, Panama, Peru, Uruguay, and Venezuela, and the company was preparing to expand in Brazil. The company also has four offices in different Mexican cities. According to the company founder, the opportunities of online advertisement and sales have reduced the company's costs and dramatically expanded its reach from a small store catering to local customers.

Urmex is one of many Mexican companies taking advantage of online opportunities. According to a 2013 survey, 68 percent of Mexican exporters leverage social networks (especially Facebook) and 35 percent use Twitter to expand their sales.<sup>b</sup> Some 81 percent use online platforms such as MercadoLibre and/or eBay (54 and 46 percent, respectively).

The majority of companies regard the security of online transactions as critical to their sales, and typically use PayPal to transmit payments. The main items sold online are shoes, health and beauty products, electronics, and jewelry. Some 36 percent of the exports go to Latin American markets, 34 percent to the US, 16 percent to Asia, especially China, and 14 percent to Africa and the Middle East.

<sup>a</sup>. Based on [www.urmex.com](http://www.urmex.com) and "motor de los negocios en México", *El Economista*, 12 September 2012.

<sup>b</sup>. Abraham Ramírez Aguayo, "Exportar en línea crea oportunidades: PayPal," *El Universal*, October 21, 2013.

particularly important issues for SMEs operating in the region include the following:

- **Network neutrality.** Small business entities are most likely to be discriminated against due to their limited leverage against Internet Service

Providers (ISPs). Network neutrality is critical to ensure that companies big and small have an equal opportunity to access a consumer. Chile was the first country in the world to codify the doctrine of net neutrality when it prohibited ISPs in 2010 from arbitrarily blocking, interfering, discriminating, or restricting the right of any Internet user to engage in lawful use of the network.<sup>13</sup> Other countries need to follow suit.

- **Small shipments.** By shipping smaller parcels to consumers, SMEs will have more limited scale economies than exporters of bulky items. As such they will benefit from schemes that combine multiple parcels into one. Also, for small exporters, customs trade compliance costs make up a larger share per parcel. One important effort to alleviate this challenge is the *ExportaFácil* programs implemented in several Latin American countries such as Brazil, Peru, and Colombia. The programs simplify customs clearance for SMEs with shipments weighing less than 30 kilograms with values less than \$5,000. The results have been substantial. In Peru, for example, the program resulted in 6,704 shipments amounting to \$3 million in sales in 2012.<sup>14</sup>
- **Data security.** Online trade requires guarantees of data security. This can be furthered by reliability rankings offered by their customers, as these help overcome bad country image or perceptions of corruption.<sup>15</sup> For example, Thailand's Department of Business Development (DBD) is giving SMEs engaged in online trade a "DBD Registered" symbol to provide a sense of security for online shoppers.
- **Electronic payments.** Fluid payment systems are critical for firms that sell online and use electronic payments to attract customers. Payments are a problem in Latin America. For example, in Brazil, where 30 million new e-consumers came online in 2011–2013, establishing a local payment entity is estimated to take six months and significant investments.<sup>16</sup>
- **On-time delivery.** Selling online places an onus on timely delivery. After all, online trade is critically based on the consumer's trust that the product will be delivered intact and on time. Slow customs clearance and other at-the-border barriers and transport inefficiencies can slow the movement of goods sold online, especially in developing countries. In a region such as Latin America where trade costs are significant, trade facilitation is imperative to enable SMEs participate in the global digital economy.

- **Untrackable packages.** One of the main challenges for regional online trade is that in many countries, packages moved by the postal service system are not trackable. The limited visibility induces fraud and customer service problems. Investing in more reliability would overcome these challenges while also helping domestic postal services by generating revenue.
- **Problems with credit card use.** Credit cards are an easy means to pay for online transactions, and some three-quarters of LAC Internet shoppers use credit cards to make purchases online. However, only 20 percent of the region's shoppers have credit cards; the rest can effect online transactions through more cumbersome traditional means, such as bank transfers. Moreover, in Brazil, the region's largest e-commerce market, 70 percent of Brazilians do not have credit cards that are accepted for international transactions, and transferring money out of the country can cost the equivalent of a 25 percent extraction fee.<sup>17</sup> These challenges also risk undermining the region's ability to attract new investments in its digital economy.

### III. Conclusion

The Internet is an increasingly crucial tool for doing business, particularly for companies that seek to internationalize. Using the web to locate, market to, and transact with foreign customers, LAC SMEs can overcome steep search costs and informational barriers that have traditionally hampered their internationalization. However, doing so requires a concerted effort by the region's governments, both to help companies use the web for export and import operations, and to enhance the region's connectivity, e-learning, and online shopping possibilities. The benefits will extend far beyond SME internationalization.

## Endnotes

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**T**his report has focused on a high-potential growth lever for Latin America and the Caribbean: internationalization of small and mid-sized enterprises. Our aim has been to offer LAC policymakers, practitioners, and private sector leaders a comprehensive overview of the status and challenges of SME internationalization in the region, and to present strategies and policy recommendations for promoting new levels of success in SME internationalization.

We started the volume with a core set of facts demonstrating that SME internationalization is a particularly powerful growth strategy for the region given the central role of SMEs in regional employment and economic performance together with the rapidly growing empirical evidence on the benefits of SME internationalization. These facts include the following:

Internationalized SMEs outperform firms that do not engage in international trade. This is true throughout the world, including in the LAC region. LAC SME exporters and importers alike employ more workers, pay higher wages, and have higher sales and labor productivity than comparable firms that do not engage in international trade. This relationship is two-fold: better-performing companies self-select to international markets, and internationalization markedly fuels firm performance. For firms, exporting is an excellent growth lever in that it increases firm productivity, boosts the sophistication of business capabilities, and loosens credit constraints, all of which are key factors if SMEs are to grow into large firms that drive trade and job creation.

LAC SME exporters are critical for LAC countries' exports, both on the extensive and intensive export margins, in terms of growth of aggregate trade and the number of export products and markets. Empirically, SME entrants that survive and export on a sustained basis can contribute very significantly to their countries' export growth. SME entrants are also critical for introducing new products to their countries' export baskets, and thus play a critical role in diversifying LAC countries' exports.

SME internationalization has important economic benefits beyond trade for LAC economies. Exporters tend to raise all boats in their home markets. By becoming more productive by exporting, exporters also reap a larger market share in their domestic markets, thus making the entire

economy more productive. SME exporters can generate positive spillovers, such as growth and job creation in the many firms they rely on for inputs, products, and services. In addition, SME exporters are widely found to help create export ecosystems in their home countries, imparting valuable knowledge and skills gained through exporting to non-exporters, and attracting followers, i.e., companies that commence exporting in the same product categories with less risk after observing the first-mover SME's export success.

These gains notwithstanding, LAC SMEs have yet to fully embrace internationalization as a growth lever, let alone succeed at internationalization on a sustained basis. Consider the following three key findings in Chapter 1:

- **Only a minority, or fewer than 15 percent, of LAC SMEs export.** Overall, LAC SMEs trail the export participation of SMEs in comparable economies. Smaller LAC SMEs participate much less in exporting than do larger SMEs, as well as their peers in other economies. LAC SMEs are, in short, relatively non-internationalized, and thus largely forego the growth gains from exporting.
- **Most LAC SME exporters are undiversified.** The typical regional exporter exports just two products to only one market, and about a third of the regional firms are single-product and single-market exporters. To be sure, the region's exporters have become smaller and younger, which helps explain the relatively limited diversification. Nonetheless, undiversified firms have little cushion: negative shocks and competitive pressures in one market cannot be compensated by sales to another.
- **LAC SMEs struggle with export survival.** About half of all LAC firms that set out to export exit the export market within a year, and most new product launches and market entries also fail. Compared to East Asia and advanced economies, LAC has low SME export survival rates. The region is marked more by ad hoc, hit-and-run exporters than by sustained exporting. While a great many firms enter exporting, a great many also exit.

### Constraints to LAC SME Internationalization

These patterns suggest that regional SMEs fail to perform on all three critical legs of the internationalization stool: export entry, export survival, and export diversification. The next question is why. This volume has singled out



three types of critical constraints along with underlying market failures that particularly impede LAC SMEs seeking to enter and thrive in the global marketplace on a sustained basis.

The first set of bottlenecks is external, i.e., factors that operate outside the firm. These costs and constraints were discussed in Chapter 3. One is sunk entry costs, or the up-front costs required for a firm to first enter a particular export arena that tend to disproportionately burden SMEs. The investment level varies by factors such as destination market and positive learning among firms within various sectors, which provides insight on managing this critical barrier.

LAC SMEs also face high trade costs that stem from deficiencies in transportation infrastructure, long customs clearance times, and high freight costs. Among other reasons, trade costs are particularly detrimental to SMEs because they make export initiatives uneconomical at low scale and because SMEs tend to lack sufficient agility to pursue investments that will ultimately raise profits per unit.

In addition, we found that LAC SMEs struggle with the costs of trade compliance. These barriers are increasingly critical in light of the proliferation of both international standards and regional trade agreements, each with its unique set of rules of origin and other market access criteria. LAC SMEs have limited time and resources to understand complex public and private standards that differ from market to market (let alone the means to invest in complying with them), from certification to traceability to basic changes in production processes.

LAC SMEs also face serious informational asymmetries and gaps when serving global markets. As with every barrier to SME internationalization, information constraints are also a two-way street. On the one hand, SME exporters are challenged in acquiring and internalizing core information on market demand, partner reliability, buyer needs, logistics alternatives, de-facto product standards, and other key issues. On the other hand, overseas buyers may lack information on the LAC exporter's reputation, and thus the quality and characteristics of its products, and thus are forced to rely on what might be a tenuous perception of the exporters' country image.

The second set of constraints to LAC SME internationalization are those internal to the firm.

Chapter 4 examined intra-firm success drivers common to SME exporters in order to shed new light on why only a portion of more efficient SMEs enter and succeed in exporting, how less efficient SMEs can improve

their productivity relative to global markets, and what can be done about it. This analysis emphasized the importance of a handful of requisite assets, such as management with relevant international background, and a suite of hard-to-build capabilities, including specific methodologies to plan for risk and uncertainty, drive high-trust high-touch relationships with key channels and buyers, and create adaptive process and product innovations by improving on existing technologies and codifiable knowledge.

Chapter 4 also explained how certain of these capabilities are exemplified by “born-global” firms. These high-value-add start-ups, often from small domestic economies, internationalize with remarkable alacrity and achievement, virtually out of the gate. The very assets and capabilities discussed in this chapter appear to consistently distinguish successful SME exporters from their less thriving peers. LAC SMEs tend to fall short in several of these areas. Yet we argued that the more an SME has fully developed each of these drivers, and is able to invest in their further improvement, the greater its odds of export success.

The third challenge facing internationalizing LAC SMEs as addressed in Chapter 5 is access to finance, the critical yet often sorely lacking fuel for SME growth and internationalization. SMEs with stronger internal cash flows and access to bank credit export earlier than their credit-constrained peers. They also export a wider variety of goods and expand to new export markets. In turn, successful exporting boosts SMEs’ access to capital.

In LAC, the financing cup is both half full and half empty. Compared to their peers in other developing regions, LAC SMEs tend to have a greater access to bank financing, and the region’s banks are increasingly predisposed to lending to SMEs. However, bank finance has steep costs in LAC: collateral requirements and net interest margins facing the regional SMEs are among world’s highest, and LAC SMEs also pay significantly higher interest premia than do larger firms. In addition, alternative financing sources such as equity, supplier credit, and supply chain finance, require further development in the LAC region so as to benefit a far larger pool of LAC SMEs.

### **How to Make a Difference?**

LAC SMEs face several constraints to internationalization, yet many companies seem to beat the challenging odds. Public policy can play a leading role to alleviate the frictions and market failures that constrain LAC SMEs’

internationalization, and thus expand the number of SMEs that export and overall SME exports.

This report has argued that policy attention must focus on three objectives: encouraging more widespread entry, supporting firms' export survival, and furthering firms export diversification, which is one of the keys to firm survival as an exporter. Policy must aim at mitigating the costs, risks, and other existing chokeholds, and at increasing gains from export entry and sustained exporting. Throughout we have stressed that policy interventions should not focus on all SMEs, but rather on those that have the greatest chances of successfully entering and growing in the global marketplace. We have also called for an integrated focus. There are no silver bullets for succeeding at SME internationalization; rather, holistic solutions are required, including SME export capacity building designed with a deep understanding of export success drivers, lowered transport costs, and improved access to finance. Each chapter on the constraints to internationalization concludes with a detailed a set of potential policy solutions.

Still, there are many ways to structure and sequence interventions. International experiences and best practices can offer guidance for Latin American and Caribbean policymakers and other stakeholders. This report has discussed several innovative international support mechanisms in export promotion and finance that can be applied in the LAC region. Select generic features of such interventions include the following:

- **Shared knowledge and experience.** By now there is ample empirical evidence that exporters can inspire and help other firms to export by transmitting knowledge about the export process and markets. Yet such externalities do not happen on their own. Rather, policy interventions can make them systematic, scalable, and impactful. Some examples might include virtual sectoral clusters and mobility initiatives to internationalize the workforce. The public sector does not only provide the venue for such knowledge transfer; it can play an important role in mitigating the sense of free-riding by non-exporters on exporters by offering incentives for the exporters to share their knowledge.
- **Pooled regional knowledge.** There are enormous opportunities to pool national and regional resources to build accessible and user-friendly information portals to guide SME exporters and export aspirants. Enormously useful would be a one-stop-shop information repository that brings together, in business-friendly language, the

many standards and rules involved in trade, foreign export markets, and export finance; such a repository should be forcefully marketed to LAC SMEs. The IDB's ConnectAmericas is an important step in this direction.

- **Scaled, customized capacity building.** Each exporter faces different circumstances. As such, one-size-fits-all advice has its limits. And while tailor-made case management can work, particularly when delivered across the full chain of support, it is notoriously difficult to scale. Even more, the specific capabilities at the heart of successful SME internationalization are inherently learning-based, incremental, and they require continual improvement. All this points to a new opportunity to move beyond one-time training. This approach would leverage technology and provide SME managers with access to a full range of essential assessments, decision-making tools, and learning activities, empowering them to engage in continuous learning throughout the export trajectory. It is also critical for export promotion agencies to identify SMEs with potential to grow in foreign markets. There is also an important need for continuous evaluation of programs and practices to support SME internationalization in order to adjust them to the evolving needs of beneficiaries.
- **Coordinated government and stakeholder action.** All too often resources and efforts to help SMEs internationalize are thinly spread across several government agencies and stakeholder groups. SME internationalization requires holistic and integrated solutions to be successful, and this should be reflected in the design, organization, and implementation of support. As such, it is critical to achieve close coordination among the many agencies that solve different facets of the challenges facing globalizing SMEs in areas such as export promotion, innovation policy, and economic development, to name a few. Similarly, there are opportunities to build synergies among the various entities that provide credit enhancements to SMEs, such as export credit and SME finance and development agencies. Coordination of programs is indispensable to exploit the synergies among the various programs and to maximize their impact.

In Chapters 7–9, this report singled out a set of immediately actionable strategies that can enable the LAC region to catalyze SME internationalization and help maximize benefits from limited support resources. This set of

strategies relies on the region's comparative advantages, and covers the following three areas:

- **Accelerating LAC SMEs' quality participation in global value chains.** With a substantial presence of multinational firms in their region, LAC SMEs have an opportunity to supply global value chains, one of the best first steps for companies to internationalize. The benefits are substantial. For one, global companies have exacting standards, putting pressure on suppliers to improve quality, drive down cost, specialize, and constantly adapt and innovate. For another, SME suppliers can benefit from information flows, technology transfer, and learning opportunities in their relationship with a multinational and/or its lead supplier. In addition, supplying a large customer can enable an SME to produce larger volumes and harness scale economies. Yet the need to shoulder new risks and investments constrain LAC SMEs in their efforts to become suppliers. Once they do become suppliers, they may not reap the benefits. A number of policy interventions can help to expand the participation of SMEs in GVCs, such as systems training and logistics technology centers that enable SMEs to meet rigorous quality standards, initiatives to induce collective action to expand access and upgrade capabilities, and support to reduce what can be enormous strains on SME cash flow through supply chain financing.
- **Leveraging the US Hispanic Diaspora to drive LAC SME exports.** LAC SMEs are exceptionally well placed to win more business in one of the largest and fastest growing markets worldwide: the US Hispanic market. With both consumer and business segments booming, this market boasts unique advantages for exports from the region. It shares an overriding commitment to the Spanish language as well as to cultural relevancy. It is also characterized by distinctive purchasing, technology, and media patterns that allow for targeted marketing. The US Hispanic Diaspora market is Latin America's to win: SMEs from any other world region would be hard-pressed to serve this market. LAC economies can do much more to help SMEs engage with this giant market, such as entering into influential relationships within the Diaspora to accelerate LAC SME internationalization, developing an in-depth repository of information, and helping LAC SME exporters pursue financing options for US market penetration.





- **Helping SMEs leverage cross-border e-commerce.** One of the most powerful ways for LAC SMEs to reach global markets is through e-commerce. Selling online essentially reduces the physical, informational, and cultural distances that limit trade across borders. The regional supply side has promise: compared with much of the developing world, Latin American SMEs are well connected to the web. And demand is growing right under LAC SMEs noses: the intra-regional online market is expanding extremely fast. Yet LAC SMEs are not fully tapping the online export opportunity. The region's companies need to be made aware of the benefits of using the Internet in promoting their business, and to take advantage of the Internet's full potential for internationalization. As such, they must learn to identify foreign markets and customers, market products and services to overseas customers, and leverage online payments. The region should also ensure that LAC SMEs have a level playing field in cyberspace, rein in taxes and fees on online purchases, and ensure that packages are fully trackable in the postal systems.

To be sure, this report is not the last word on SME internationalization in the LAC region. There is much room for further empirical research on the bottlenecks specific to LAC SME internationalization, and for developing further actionable solutions and practical tools for fully unleashing the growth opportunity of SME internationalization. It is our hope this volume has demonstrated the enormous opportunity represented by LAC SME internationalization for the regional economies and citizens, and has also inspired fresh thinking and coordination on the best ways to seize that opportunity—starting today. Much has already been accomplished in the region. At a time of stiffening global competition for export market share and for foreign direct investment, these efforts will now have to be stepped up. The payoff is well worth the work.