

Going Global

Promoting the Internationalization of Small and Mid-Size Enterprises in Latin America and the Caribbean



Integration and Trade Sector
Vice Presidency for Sectors and Knowledge

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Executive Summary



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Introduction

Nations around the world have identified exports as a key for economic growth. This is clearly the case in Latin American 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 non-technical 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 two-fold: 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 reputa-

tion 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.