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Linkages, value chains and outward investment:[1] Internationalization patterns of developing countries' SMEs[*]

Note by the UNCTAD secretariat

Executive summary

The São Paulo Consensus stated that UNCTAD should continue its work on enterprise development, taking into account developments in the international economic environment, and pay particular attention to the international dimension in order to identify opportunities for and obstacles to progress in economic development. In recent decades, globalization has greatly affected the business environment for SMEs in developing countries, with international competitiveness becoming increasingly important for their survival. From a policy perspective, it has become of utmost importance to understand under what conditions developing-country firms, and in particular SMEs, can benefit from internationalization processes and whether this could lead to a new and mutually beneficial form of South-South cooperation.

This issues note examines key developments in the area of enterprise internationalization to identify major factors that could enhance the international competitiveness of developing-country firms given the changing environment and rapid globalization. The note discusses opportunities and threats created by globalization for developing-country SMEs and how the latter can better utilize these opportunities and become global players themselves. In particular, it discusses recent trends in outward investment from developing-country firms as a means of accessing strategic assets, technology, skills, natural resources and markets and improving efficiency. It also examines possible forms of integrated production networks, with specific reference to TNC-SME linkages and global value chains.

[1] This study refers only to outward foreign direct investment (FDI).
[*] This document was submitted on the above date owing to technical delays.

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Introduction

1. As already mandated by the Bangkok Plan of Action, the São Paulo Consensus, adopted by UNCTAD XI in June 2004, reaffirmed that UNCTAD should assist developing countries in designing and implementing active policies for building productive capacity and international competitiveness (São Paulo Consensus, para. 49) to support their efforts to attract and benefit more from FDI.

2. In the past four years, UNCTAD has organized a series of Expert Meetings on issues related to the competitiveness of domestic firms, in particular SMEs, including export competitiveness, with a particular focus on business linkages. To take stock of the findings, the secretariat has created a compendium titled "Improving the Competitiveness of SMEs through Enhancing Productive Capacity". One of its main messages is that the concept of competitiveness is systemic, and that competitive advantages are largely created by deliberate collective actions and policies addressing not only the macro but also the micro and meso levels.

3. Competitiveness can be defined *as a nation's ability to produce goods and services that meet the test of international markets while simultaneously maintaining and expanding real incomes of its people over the long term* (UNCTAD 2003a). Evidence shows that developing countries can succeed in complex industrial exports without going through TNC networks if they are able to build the necessary indigenous base of technological capabilities. However, the changing international context may suggest that much export growth in the future will be situated in or around TNCs and global value chains.

4. Integrating global value chains and linking up with TNCs can be important means for domestic companies, and in particular SMEs, to gain access to certain critical resources such as finance, technology and managerial skills. However, attendant risks and costs may need to be addressed through appropriate policies and measures. Another way of accessing strategic resources is via outward FDI from developing-country firms.

5. This paper considers issues related to internationalization of developing-country firms through outward FDI and global value chains. After considering the potential opportunities and threats created by globalization for developing-country SMEs, it discusses recent trends in outward FDI, including whether this type of investment is different from FDI by developed-country firms and represents a real opportunity for South-South cooperation. It also examines how domestic SMEs that have not chosen the path of direct internationalization can access global markets through integration with global production and distribution chains.

I. Globalization and SMEs: challenges and opportunities

6. In recent decades, globalization has drastically altered the conditions of competition at the firm level all over the world, in the international as well as the domestic arena. The new international environment opens up many opportunities in terms of access to new technologies, skills, capital and product markets, economies of scale and reduced transaction and R&D costs. The reduction of trade barriers owing to trade liberalization and openness affects SMEs positively, since it facilitates their expansion into international markets and their integration into international production networks and supply chains and enhances their growth possibilities.

7. At the same time, SMEs face increased competition in both domestic and international markets. Domestically, they have to compete with imports, new foreign investors and expanding large domestic firms. SMEs may also face stronger competition within developing countries for export markets, foreign investment and resources (Wignaraja 2003).

8. SMEs' ability to reap the potential benefits of globalization depends on how well they are prepared for the new market conditions and the increased competition on the global market. Generally, developing-country SMEs are not well prepared, and few of them today are in a position to benefit from globalization.

9. According to Wignaraja (2003), globalization leads to export expansion and growth for only 5 to 10% of all SMEs. The size of the more competitive and dynamic group of SMEs varies among developing countries. East Asia seems to have a higher proportion of dynamic SMEs than other developing regions, while in Africa, the Caribbean, Central America and South Asia this group of SMEs is likely to be much smaller.

10. Many of the barriers that SMEs face are at the national level. Competition policy, legislative and regulatory frameworks, telecommunication infrastructure, research and education policy are all factors that influence to what extent SMEs are prepared to enter the global market (OECD 2004). However, despite the fact that SMEs are extremely important to developing countries, not least as contributors to employment and growth, the sector is often neglected by governments, which tend to favour larger firms (Dhungana 2003).

11. Although many SMEs still rely mainly on domestic markets, the internationally active share of SMEs is increasing. SMEs are becoming more involved in strategic alliances and joint ventures, both with other SMEs and with larger multinational firms. Networking allows SMEs to combine the flexibility of small-scale businesses with advantages of large firm groups, such as economies of scale. Creating linkages with TNCs and other SMEs induces many opportunities for SMEs in developing countries to expand their production and increase growth. Relationships with TNCs give them access to knowledge and new technologies as well as investment.

12. The increased presence of TNCs in local markets in developing countries does not always benefit SMEs. New actors mean stiffer competition. Furthermore, TNCs do not necessarily choose local suppliers to provide them with products and services. In Latin America, the acquisition by TNCs or affiliates of privatized enterprises in the telecommunication and energy sectors has caused the decline or even closure of engineering SMEs and other types of business support providers. Trade liberalization has also allowed some foreign affiliates to import intermediate products from their own already globalized supply chains or from other well-established ones, rather than sourcing locally. Consequently the local SME capacity in manufacturing or services decreases or disappears (Katz 2001).

13. Trade liberalization also means more competition internationally. Another problem is that high tariffs have been maintained for many products of importance to SMEs in developing countries. Evidence shows that even in Asia and the Pacific, trade liberalization has not brought the expected large gains for the SME sector. In many countries, demand for domestic products has diminished in favour of imported products, and competition has driven many SMEs out of business (Dhungana 2003).

14. The liberalization of financial markets has made it easier for larger SMEs to gain access to international capital markets. For the majority of SMEs in developing countries, access to capital is still a major problem that seriously affects their ability to improve their competitiveness. The limited access to capital results not only from lack of information about available possibilities but also from the companies' small size, which makes it difficult for them to obtain the capital they need. Considered high-risk borrowers, SMEs generally have to pay much higher interest rates than larger firms; in in many African countries the interest rate exceeds 30% (Kwaku 2003). There is also a fear among developing countries that the new Basel II regime, a framework for regulatory capital and risk management, will have a negative impact on the already limited capacity of local banks to lend to SMEs, since it will impose higher and more restrictive lending ratios on commercial banks (UNCTAD 2004a). Specific financial measures will be needed in order to improve the financial situation of export-oriented SMEs and thereby facilitate their continuous expansion into global markets.

Box 1
The case of Latin America

An example of the impact of trade liberalization is the Brazilian automotive sector, where import liberalization has led foreign affiliates to source globally more than domestically. The number of national SMEs and larger producers of parts dropped from 2,000 in 1990 to 750 in 1993. A similar trend can be observed in Argentina's car industry. Several Latin American economies have experienced "the paradox of having moved forward to product and technology design closer to the international technology frontier but also, at the same time, to the assembly of imported components rather than to their local fabrication" (Katz 2001). Still another example is Guadalajara, Mexico's rapidly growing agglomeration of export-oriented TNC affiliates in the electronic industry. Some global suppliers have followed several leading electronics TNCs. For certain intermediary products, no local suppliers or SME subcontractors were present, but for others, local companies have not been able to handle the new competition or have been taken over by foreign investors.

Source: UNCTAD (2000a); Katz (2001).

15. Other major problems affecting the internationalization of SMEs are lack of resources and unfriendly business environments. Particularly in Africa and Latin America, the business environment does not always seem to be conducive to entrepreneurship, and there is generally a lack of necessary support services (UNCTAD 2000b). Furthermore, business environments in many developing countries prevent small firms from expanding into medium-sized enterprises with more possibilities for linking up with larger firms and TNCs.

16. Another major constraint is the increasing number of international and corporate production standards in terms of technology, health, quality and environment. These standards tend to become a new type of trade barrier hindering SMEs in developing countries from expanding into international markets and limiting their chances to become suppliers of TNCs.

II. Internationalization through outward investment by developing-country firms

17. Since the 1980s a new trend of outward FDI from developing countries has been emerging. This trend should become stronger as barriers to outward FDI diminish in the developing world. This might be an opportunity for developing countries that seek to attract FDI, as developing-country firms have shown a much larger propensity to invest in developing economies than their counterparts from developed countries. Actually, the real impact of this phenomenon still needs to be analysed.

18. Not all developing regions participate equally in the emergence of international investment flows. Asia (particularly East and Southeast Asia) was by far the largest outward investor, followed by Latin America and Africa (South Africa). While some developing economies such as Malaysia, the Republic of Korea, Taiwan Province of China and Singapore have already consolidated their position as outward investors, others such as China, South Africa and Chile have become players relatively recently. Others, such as India, Mexico, Brazil and Argentina, whose firms have been investing abroad for many years, registered new momentum in their outward flows during the 1990s, after stagnation during the 1980s.

19. Dunning et al. (1996) have identified two waves of FDI from developing-country firms. During the first wave (in the 1960s and 1970s), firms from Asia (Korea, Hong Kong, Singapore, Malaysia, India) and Latin America (Argentina, Mexico Brazil) had the most significant presence and were mainly driven by efficiency- and market-seeking factors and mainly directed towards other developing countries, most

often neighbouring ones. The second wave of outward FDI from developing countries began at the end of the 1970s and was led by firms from Hong Kong, Taiwan Province of China, Singapore and Korea, while Latin American and Indian firms have, at least at the beginning of this wave, been losing ground (Dunning et al. 1996).

20. In this second wave, there has been a fundamental shift in both the character and the motivation of outward FDI from developing countries, which became more strategic and asset-seeking in nature, and more directed to developed countries and to developing countries in other regions. Dunning argues that the second wave of outward FDI is the result of liberalization of markets, globalization of economic activity and dramatic technological advances within sectors, which have affected the structure of the world economy. He also asserts that the countries leading the second wave are those that have moved along the Industrial Development Path (IDP),[2] experiencing rapid economic growth, restructuring and development.

21. Since the early 1990s, new developing countries have emerged (or re-emerged) as the source of significant outward FDI flows: Latin American countries such as Argentina, Brazil, Chile and Mexico, as well as China, India and South Africa. The most striking case is China, which has been able to become one of the most important outward investors among developing countries within a very short period.

Box 2
Recent trends in outward FDI from China

China is now one of the top FDI exporters among developing countries, and its share in developing countries' outward FDI stock has risen dramatically, from 0.2% in 1985 to 4.3% in 2003 (UNCTAD 2004b). Access to natural resource markets, acquisition of strategic assets such as advanced technology and manufacturing know-how, and promotion of China's exports are the main driving forces. Chinese overseas investment is spread across the globe. Although North America (the United States and Canada) is still the main destination and received 22% of approved Chinese outward FDI in 2001, this region's share has declined compared to 1991, when it reached 46%. Important new targets for Chinese overseas investment have emerged, including sub-Saharan Africa, the former Soviet bloc, the Middle East and Latin America.

Chinese outward FDI was initially directed by the state, and only state-owned and -regulated enterprises were allowed to invest overseas. With the liberalization of restrictive policies during the late 1980s, non-state firms were permitted to invest abroad provided they had sufficient capital, technical and operational know-how and a suitable joint venture partner. The current decade has seen the consolidation of China's outgoing strategy. Enterprises producing light industrial goods (such as textiles), machinery and electrical equipment were specifically encouraged to establish overseas manufacturing projects that could process Chinese raw materials or assemble Chinese-made parts that could eventually spur China's exports.

More recently, the Government of China has been actively involved in creating conditions for a strategic partnership with some Latin American countries. During a state visit by China's President to Brazil and Argentina in November 2004, multibillionaire trade and investment deals were announced. An agreement was signed with Argentina to expand cooperation in the fields of oil and gas, mining, space technology, education, tourism, railways and trade. Cooperation and joint ventures with Brazil have been envisaged in the areas of mining, oil, electricity, mobile phones, airlines and trading.

Source: Wong and Chan (2003); UNCTAD (2003b); Economist Intelligence Unit (2004).

[2] Dunning's IDP model suggests that a country's outward and inward FDI are partly a function of its level of development, and that countries go through stages as the home economy develops (Dunning 1988).

22. The increasingly fierce competition seems to make investment in foreign markets more and more of a necessity in order for companies to maintain or strengthen their competitiveness. Investing abroad gives developing-country firms access to new resources and has for many enterprises become an important part of their corporate strategy. For recipient developing countries, it means a new source of capital and access to technology and skills.

23. Most of the extant literature addressing the issue of the impact of outward FDI from developing-country firms on developing-country host economies refers to the first two waves mentioned above. However, many findings of the previous literature can be still considered relevant. In this respect, while many authors agree that most general effects on developing countries of outward FDI from developing-country firms are likely to be similar to the effects of FDI from developed countries, some have also identified specific characteristics that point to a different kind of impact.

24. Kumar, for example, notes that because the capital resources and technical and managerial capabilities of developing-country firms are limited, they often need partners in host countries who can contribute capital and other strategic resources and serve as brokers with local authorities (Kumar 1982). They thus have a greater propensity to establish linkages with local firms than their counterparts from developed countries. This in fact means a deeper integration into the local economy that could be particularly beneficial to the development of local SMEs.

25. Additionally, developing-country firms may have competitive advantages in the use of mature technologies and in the production of goods competing on price. The technologies that they transfer are thus generally more suited to the conditions of developing countries, inasmuch as they are labour-intensive and can efficiently use locally available inputs. Moreover, the advantages that developing-country firms have in such mature technologies are generally weak and may be overcome rapidly by local firms willing to catch up with them, something that could represent an incentive for local technological upgrading (Wells 1983; Kumar 1982). Finally, according to Kumar, the terms of technology transfer by developing-country firms are generally more favourable to host countries than those of transfer by industrialized countries' firms.

26. However, developing-country firms may also bring disadvantages to their hosts. For example, owing to the lack of R&D facilities, they might not be able to provide a continuous flow of upgraded technologies meeting international standards to their subsidiaries or joint venture partners (Wells 1977). While Kumar recognizes the solidity of this argument, he also argues that most of the largest firms from developing countries have made significant progress in acquiring new technologies and are likely to continue doing so to survive in the market (Kumar 1982).

27. Some authors also argue that developing-country firms, at least in early stages of their outward expansion, tend to rely heavily on expatriate staff for management and technical positions instead of hiring nationals from host countries, since they have not yet developed the systems that industrialized countries' firms use to transfer management skills to their personnel (Kumar 1982; Lecraw 1977). Kumar argues, however, that this situation generally changes at a later stage, with the accumulation of overseas experience and the pressures exerted by host countries.

28. In general, beyond considerations of positive or negative impacts on host developing economies, the growth of developing-country firms and their increasing activities in the developing world raises expectations of stronger economic relations between developing countries. It is generally expected that partnership between developing countries' firms will be boosted and integration of less developed countries' firms into the value chain of outward investors from the South will be enhanced. However, as it applies to FDI in general, the potential of outward FDI from developing countries to contribute to enterprise development in host developing countries cannot be realized automatically, and the issue of how developing countries can take advantage of the increase of FDI from other developing countries needs to be further addressed from a policy perspective.

29. Negligible until the early 1990s, FDI outflows from developing countries accounted for over one tenth of total world stock and some 6% of total world flows in 2003 ($859 billion and $36 billion, respectively) (UNCTAD 2004b). They have traditionally been dominated by TNCs. However, lately SMEs have started to emerge as outward investors, especially in Asia, and their contribution in this sense is becoming an increasingly important factor for economic growth (Cho 2003).

30. Data on outward FDI by SMEs are still very limited. One country where it can be found is the Republic of Korea. The country has recently seen a large increase in its outflows of FDI by SMEs. SMEs active in foreign investment increased from 16% of total SMEs in 2000 to 37.6% in 2002 (OECD 2004). The majority of the recipients of FDI from SMEs from the Republic of Korea are other developing countries, mainly within Asia (UNCTAD 1998).

31. FDI by SMEs can therefore be seen as complementary to FDI by TNCs in the transfer of productive resources and technology, which can contribute to enhancement of the growth and competitiveness of developing countries (Cho 2003). Certain characteristics such as greater flexibility, capacity to serve small communities, relatively labour-intensive technologies and greater adaptability to local economic conditions can in some cases make SMEs better suited to conditions in other developing countries than TNCs (Dhungana 2003).

32. FDI from SMEs has the potential to increase the international competitiveness of the SME sector in both home and host countries. It creates new opportunities and benefits not only for the investing firm and its partner but also for other firms through forward and backward linkages and thereby spillover effects in terms of technology, knowledge and productivity. It can also help fill the "missing middle" by promoting the growth of medium-sized enterprises. Evidence shows that, compared to FDI from large enterprises, FDI from SMEs is more likely to lead to multiplier effects through linkages to local industry (UNCTAD 1998). Nevertheless, one must also be aware of the risks that SME FDI can bring, such as crowding out indigenous firms in the host country if these are not able to respond to the increased competition that foreign investors impose.

Box 3: Driving forces of outward FDI by developing-country firms

Desire to explore and open up new markets or secure foreign market access by circumventing trade barriers: This is the case for trading enterprises operating overseas in the early stages of a country's economic development, which help promote exports by marketing and distributing in the host countries.

Saturation in home market: This might result from increasing competition in the home market or a dramatic expansion of production capacity at home.

Secure access to raw materials and natural resources: This includes investments in infrastructure (roads, railways, port facilities) that facilitate trade.

Stiffer price competition: Faced by more price-driven competition, firms from developing countries may choose to relocate some of their production facilities to lower-cost developing countries.

Improved competitiveness at home: Together with "ownership-specific advantages", improved competitiveness in the domestic market have pushed some big enterprises from developing countries to go offshore to operate near their clients and expand their growth opportunities in markets abroad**.**

Need for globally viable competitive advantages: To become globally competitive, enterprises from developing countries may engage in strategic assets-seeking FDI, locating some production activity in the major developed-country markets so as to acquire advanced technology, manufacturing know-how and modern marketing and management expertise, as well as avoid protectionist policies.

33. Several factors driving outward FDI from developing countries are outlined in Box 3 (on the preceding page).

34. According to a survey by UNCTAD (1998) of the characteristics of FDI from Asian SMEs, the reasons for investing abroad are to a large extent the same for SMEs as for larger firms, though the relative importance of various factors might differ. These factors can be divided into four main groups: push factors (rising costs in the home market), pull factors (growth opportunities, lower costs of production, government incentives), management factors (having the skills and knowledge to internationalize successfully) and, finally, chance factors (being in the right place at the right time, being invited to supply a costumer abroad or to form an alliance with a foreign partner).

35. In particular, major incentives for SMEs to invest abroad are the opportunities to explore new and growing markets as well as to take advantage of lower production costs. Chance and management factors also heavily influence SME decisions on investing abroad. Management factors seem to be of particular importance to medium-sized enterprises, while chance factors are more important to small enterprises. In relation to other factors, push factors such as rising costs and increased competition in the domestic market tend to have less influence on SMEs' investment abroad. Government pull factors (e.g. various investment incentives) seem to be much more important to medium-sized and large enterprises than to small firms (UNCTAD 1998).

36. Furthermore, some SME subcontractors follow the large enterprises they supply when these internationalize their activities and move abroad. Today many TNCs have close relations with their suppliers. Following their clients abroad, the supplier firms therefore usually know that their products will have a market waiting for them (Dhungana 2003).

37. The most common investment form for SMEs is through partnership and networks with already existing local SMEs in the host country, especially in the form of joint ventures. About half of the foreign investments from SMEs in Asia are in the form of a partnership or alliance (UNCTAD 1998). Greenfield investments are less common, since these generally imply much larger risks and financial commitments for the investing enterprise. By using existing local enterprises, the investor can benefit from local knowledge and contacts while the local partner gains from access to capital, technology and training. In comparison to large firms, SMEs are more likely to develop linkages with local enterprises and supply productive inputs locally. Strategic and financial decisions are also more commonly taken in the host country. Other factors seen as more important by SMEs are training of unskilled staff and local managers with a view to providing products suited to the needs of the local market (UNCTAD 1998).

38. There seems to be a tendency among smaller enterprises in developing countries to invest in neighboring countries. This is mainly the result of factors such as geographical proximity and cultural and ethnic ties. Trade relations and ethnic and cultural ties result in relatively in-depth knowledge about neighbouring markets. By investing in these markets, SMEs can reduce the large costs associated with gathering information about the foreign market (UNCTAD 2004b). In Asia, intra-regional investment flows, in particular in the form of joint ventures, have greatly increased, a development that has been facilitated and promoted by the establishment of subregional economic cooperation frameworks such as ASEAN (Dhungana 2003).

39. SMEs investing abroad can normally be found among the more growth-oriented SMEs. These constitute a relatively small fraction of SMEs but make a large contribution to the economy. Foreign investments are also more likely among SMEs that already have some international experience. The exception is high-technology SMEs, which more often tend to start investing abroad despite lack of international experience. Exporting and licensing are common first steps into foreign markets. Experience shows that SMEs normally internationalize their activities faster than large firms. For Asian SMEs, the period from establishment to first international activity is 0.7 years, compared with 3.9 years for large firms (UNCTAD 1998). Since FDI tends to be the last step in the internationalization of SMEs, it should

be in the interest of governments to encourage other forms of international activity in order to eventually also increase the level of FDI by SMEs.

40. SMEs facing abroad face several impediments and barriers. Problems exist within the firms themselves as well as in the host and home countries. Common internal problems are shortcomings at the management level and lack of international experience. A major problem for SME investors is the lack of information on investment opportunities and local conditions. Macroeconomic uncertainties and corruption also constitute major problems for SMEs, which generally are more affected than larger firms by these problems and the additional costs that they impose.

41. Other impeding and cost-increasing factors are underdeveloped infrastructure, in particular the telecommunication and transport system, cultural differences, and limited access to finance. Furthermore, SMEs are generally unfamiliar with the legal system and regulation that investments involve, and the policy environment is rarely adapted to encourage FDI by SMEs. Another major impediment for SMEs is difficulty in finding a suitable partner. Since the majority of SMEs investing abroad are looking for local SMEs to partner with, it is important that host countries encourage the development of their SME sectors so that local enterprises have the capability to form alliances or joint ventures with the investing SMEs from abroad (Cho 2003; UNCTAD 1998).

42. However, some countries have started to facilitate SMEs' internationalization by changing policies and regulations to better suit smaller firms. For example, in countries like Indonesia, Malaysia and Thailand, minimum size requirements for foreign investments have been abolished. These minimum requirements have been used in many countries, partly to protect their own SMEs from foreign competition. One-stop agencies for FDI promotion are also being created in order to reduce the number of clearance formalities (Cho 2003; UNCTAD 1998).

43. For outward investment from SMEs to increase and bring about the potential benefits, it is crucial that efforts are made within the enterprises themselves as well as at the governmental and international level to create a business environment conducive to SMEs and their development. Actions need to be taken in both home and host countries. The home country can promote FDI from SMEs by providing domestic enterprises with factors such as necessary skills, financial services, incentives, and accurate information on business opportunities. In the host country, it is important to develop and implement policies to encourage SMEs to become suitable partners for FDI, as well as to provide foreign investors with a well-functioning infrastructure and access to necessary services and information. Also of major importance is the development of a cooperative environment between governments. Here international organizations have an important role to play (UNCTAD 1998).

III. Global value chains as a way to upgrade the capabilities of domestic SMEs

44. The previous section pointed out that investing abroad as a way to gain and strengthen competitive capabilities requires SMEs to have already established a comparatively high degree of technological capacity. However, many firms in developing countries do not have such capabilities. For those companies, one way to gainfully integrate into the global economy could be their incorporation into international value chains.

45. Value chains are networks of cooperating firms that are involved in the full cycle of bringing a product from the design and conception phase through the intermediary phases of production all the way to delivery to the final consumer and, if necessary, disposal after use. Value chains do not focus solely on processes within one single firm; rather, they involve different firms located in various places and linked together in a chain. Specific suppliers and buyers are tied together, facilitating the flow of information about markets, efficient production processes and possible logistics. In an ideal case, buyers offer

significant order volumes and stability in relation to the quantity demanded and the prices paid (Humphrey 2004).

46. Each link in the chain adds a certain amount of value to the final product. Since value chains do not focus merely on the physical transformation of inputs within one firm, they offer the possibility of capturing economic returns that can be found in different links in the value chain. While the realization of primary economic returns used to lie in activities related to production, these returns have increasingly shifted to areas outside production such as design, product development, branding and marketing (Kaplinsky 2000; UNIDO 2001).

47. The challenge for producers within value chains is to determine how and where (in which markets) to position themselves so as to best reap the benefits of globalization. In many cases, firms are already participating in global markets, but at a very low level of economic value added. What they need in order to create competitive capabilities is the capacity to continuously upgrade their activities so as to appreciate their returns. This is a complex process, but SMEs do not always depend solely on themselves in their upgrading process. Having a competitive supplier base for inputs is of great benefit for TNCs, and often it is the large buyer company that supports SME suppliers in upgrading their activities. Box 4 (on the next page) gives an example of an SME upgrading support programme implemented by TATA Motors, India's largest auto manufacturing firm.

48. Finding the right way to access value chains and appropriate largest returns possible is not always easy. According to Kaplinsky and Morris (2001), two main paths exist for SME insertion into the global economy, which they refer to as the low and the high road. The low road is what they describe as a path of "immiserizing growth". This occurs if, despite an increase in their economic activity, firms' returns decrease (for example, if increased exports can only be paid for by lower wages, or export prices fall faster than export volumes increase).

49. Empirical evidence shows that many firms, after expanding their participation in global markets, are worse off than before. Likewise, countries in some cases realize decreasing terms of trade despite an increase in overall economic activity. The underlying problem in those cases is often that firms specialize in highly competitive markets, frequently in activities with low levels of added value. For those markets, barriers of entry are relatively low, and with increasing competition, firms easily find themselves in an extremely vulnerable position, with their returns subject to erosion in a sort of "race to the bottom" (UNIDO 2001). When an increasing number of firms are able to transform physical inputs into high-quality outputs at very low cost, and there is consequent pressure among firms to produce at lower and lower prices, this leads to a reduction in terms of trade of exports of developing-country producers (Kaplinsky 2000).

50. On the other hand, evidence also shows cases where firms, regions or countries have greatly benefited from the reduction in global trade barriers. Major beneficiaries include East Asia (after the 1960s) and China and India (since 1980) (Kaplinsky and Morris 2001). These countries have managed to follow the "high road" of insertion into the global economy, with their firms generally able to compete successfully in globalizing markets.

51. It should be clear that performing activities in links of the chain with higher levels of value added significantly reduces a firm's vulnerability. Indeed, the capacity to innovate, to realize continuous improvements in product and process development, is key for beneficial participation in international value chains. However, when talking about upgrading SME activities in a value chain context, one has to take into account that upgrading may include a reorganization within each link in the chain as well as a possible functional redistribution of intra-chain activities.

Box 4: Tata Motors' Experience in Value Chain Upgrading

Established in 1945, today Tata Motors Limited (TML) is India's largest auto manufacturer. The company has assembly operations in Bangladesh, Malaysia and South Africa and exports to over 70 countries in Europe, Africa, South America, the Middle East, Asia and Australia. Recently India's economy has been undergoing structural change, moving from being a controlled economy with import substitution, vertical integration, and limited domestic capacity to being an open economy with firms increasingly outsourcing inputs as a predominant strategy for gaining competitive advantage. This change has deeply affected the auto industry, where the concept of value chains, their organization and management has started to play a key role influencing whether firms remain competitive. TML, for example, has dramatically increased not only the quantity but also the value content of its outsourced parts. The company's strategy shifted from contracting out some activities and operations in the pre-liberalization period to outsourcing parts and aggregates in the early 1990s, and today suppliers are involved in developing systems and technology today.

Since TML cannot maintain its competitive advantage without having a competitive vendor base, a three-pronged approach to beneficial development and upgrading of its suppliers was developed to ensure an efficient process flow within the value chain:

- Encourage global technology partnerships, including involvement in product development
- Improve supplier capabilities and competencies in terms of quality, productivity and costs
- Provide business opportunities (vendor rationalization by eliminating non-competitive firms and fostering competitive ones)

Furthermore, the upgrading support for TML's SME suppliers features the following elements: declaration of supplier status, technical support for development as well as quality, project guidance, tooling support, financial support, training support, guaranteed business and raw materials support in special nature. The TNC constantly monitors the quality of its suppliers' products and processes.

SME suppliers to Tata Motors have benefited greatly from this upgrading programme. Upgrading their activities has helped them not only grow faster but also better manage the cyclical nature of the automotive industry and survive recessions.

Source: Presentations by Radvi Kant and Bikash Mukherjee (UNCTAD, Expert Meeting on Improving the Export Competitiveness of SMEs, Geneva, 2004).

52. To better understand the opportunities and upgrading possibilities that value chains offer to SMEs, one needs to consider that value chains are not homogeneous, and that the opportunities for rent appropriation by different parties can vary from chain to chain. Essentially, however, there are four paths economic actors can follow when threatened by competition (Kaplinsky 2000). These paths are not mutually exclusive and include (a) process upgrading; (b) product upgrading; (c) functional upgrading; and (d) chain upgrading.

53. While process upgrading relates to increasing the efficiency of internal processes within a firm (by reorganizing the production system or introducing new technology, firms may transform physical inputs into physical outputs more efficiently), product upgrading describes the process of improving old products or bringing new products to the market – that is, moving into more sophisticated product lines with increasing value added.

54. While process and product upgrading are readily understood, they are probably least likely to offer a bigger share of value chain returns. As experience shows, even if firms upgrade in these areas, if

they remain specialized in those links in the value chain that are subject to fierce competition, there is a high risk that this concentration will lead to "immiserizing" growth. Process and functional upgrading are nevertheless to be regarded as the necessary conditions for remaining competitive or extending participation in the global economy and can be stepping stones for further upgrading in a value chain system.

55. Functional upgrading refers to increasing value added by acquiring new functions or abandoning existing ones so as to increase the overall skill content of a firm's activities. Functional upgrading is a bit more complex than process and product upgrading because it includes changing the mix of activities within the respective links but possibly also moving to other links in the value chain (UNIDO 2001). As was mentioned before, since the appropriation of economic rents has generally shifted from production to activities outside production such as design, product development and marketing, moving to other links in the chain that are characterized by a higher level of value added is surely a good way for local firms to upgrade (Kaplinsky 2000).

56. Sometimes, however, barriers to entry throughout the chain are too low to allow firms to upgrade. In such a case, the optimal path for a firm would be chain upgrading. By chain upgrading, firms may use specific capabilities acquired in one sector to enter another sector. This inter-sectoral upgrading is one of the characteristics of industrialization in Taiwan Province of China. Some Taiwanese firms shifted their competences from manufacturing transistor radios to calculators, and, after using their knowledge to manufacture television sets, moved on to produce PC monitors, laptops and finally WAP phones (Pietrobelli and Rabellotti 2004).

57. Functional and chain upgrading, although complex to realize, may offer the best possibilities for SMEs to build competitive capabilities. Difficulties may arise because the degree of upgrading, especially moving to links adding higher value in the chain (e.g. marketing or design), often depends greatly on the form and degree of chain governance. Global production networks are increasingly coordinated by key lead firms (mostly buyers) that not only determine which firms form part of the chain but also set the conditions that producers have to fulfil in order to participate in these chains; monitor standards; and help producers achieve these standards.

58. Since areas that allow for substantial rent appropriation are mostly domains that are highly protected by large powerful global buyers, it can be difficult for SMEs to access these activities (Kaplinsky 2000). However, even though intra- and inter-chain upgrading may be complex to realize, examples like TATA's and the experience of the Taiwanese firms illustrate the feasibility of these types of upgrading.

59. In conclusion, evidence shows that participating in global value chains opens up new opportunities for SMEs to gainfully integrate into the global economy. However, the benefits of being part of a chain do not seem to materialize automatically. SMEs are required to act proactively and to continuously look for opportunities to upgrade their activities, taking into consideration the fact that, since value chains are increasingly coordinated by lead firms, these are the ones that predominantly determine not only which firms participate in the chain but also the scope firms have for their upgrading activities. To strengthen the position of SMEs in global value chains, joint action by governments, chain-governing key firms, SMEs and multilateral organizations is therefore required.

60. The role of governments in this context is multifunctional, with possible support ranging from informing producers about risks and opportunities associated with specific value chains to assisting producers entering these chains, as well as using specific policy instruments to facilitate the upgrading process within and across production networks (Kaplinsky 2000).

61. Since it is of key importance for key chain-governing firms to be able to rely on a competitive supplier base, their role is to ensure effective functioning of the chain. As the example of Tata Motors shows, a highly efficient way to secure a good vendor base might be to allocate resources to supply chain

learning and development, thereby providing SMEs with the skills necessary to ensure a sustainable increase in their competitiveness.

62. Finally, the international community could support SME upgrading by identifying and promoting partnership programmes between SMEs, TNCs, governments and international organizations in order to allow for continuous dialogue between all stakeholders. Furthermore, it could provide relevant information (e.g. market and sectoral information) and contribute expertise in specific fields (UNIDO 2001).

Conclusions

63. The new international environment has opened up new opportunities for firms in developing countries. However, so far only a fraction of existing SMEs have been able to reap the benefits of these opportunities. For many SMEs it has become more and more difficult to compete successfully, both domestically and internationally. Appropriate policies for internationalizing the SME sector in developing countries are therefore needed.

64. The comparative advantage of developing countries has traditionally been considered to lie in natural resource endowments and low-cost labour. Under the new competitive conditions brought about by globalization and liberalization, the focus of competitive advantages has shifted to core production functions and has become knowledge-intensive in all sectors of the economy.

65. In particular, it is clearly necessary to better understand why some companies or countries end up on the low road to competitiveness and others on the high road, and what options developing countries' firms have for upgrading their activities to appropriate rents that provide for sustainable growth. The role of public-private partnerships (including the international community) in this context needs to be better clarified, as well as the conditions under which lead firms decide to embed themselves in local productive systems and establish long-term relationships with suppliers.

66. In many developing countries, a deep process of liberalization, deregulation and privatization seem to have dramatically emphasized (rather than reduced) the need for policy interventions at the micro, meso and macro levels. In particular, urgent measures are needed in order to reduce structural heterogeneity in the industrial sector, reintegrate workers from the informal to the formal sector, and reduce the productivity and technological gap of domestic SMEs both internally (with larger firms) and with external economies.

67. There is also a need to further examine the internationalization patterns of developing-country firms, the most recent outward investment trends among developing countries, and their possible beneficial impact on economic development by collecting micro-level data and analysing the potential for technology spill-overs with respect to host country firms, as well as assessing the conditions for South-South joint ventures and cooperation agreements. Finally, there is a need to better define what kind of constraints international agreements concretely imply from a policy perspective, and what national space is left to developing-country governments, beyond (export) subsidies and incentives, to increase the international competitiveness of domestic companies.

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