KIEP

Opinions

October 16, 2014

# SME Internationalization: Significance and Policy Challenges

Jeong Gon Kim

Ph.D., Research Fellow, Cooperation Policy Team
Korea Institute for International Economic Policy

The internationalization of SMEs has been emerging as one of key policy challenges for many countries, including Korea. While this is not a novel issue, SMEs have been receiving newfound attention as major economies like the US and EU seek drivers of economic growth in response to the economic recession brought on by the 2008 financial crisis. Some good illustrations would be the US National Export Initiative, the Small Business Act for Europe, and the SME globalization policies implemented as part of Abenomics. The Korean government is joining in this trend by realigning its supportive measures for SMEs looking to make inroads into overseas markets.

With a limited number of large firms dominating international trade, the number of companies engaging in export activities is very small. As a case in point, the top 10% of companies in the US account for 96% of total exports, while in the EU the top 10% account for 85% of total exports. The same goes for developing countries, where 81% of exports are concentrated in the top five enterprises in terms of company size.[1] This phenomenon becomes even more prominent when it comes to FDI.

With enterprises exceeding a certain size leading global trade and investment, how significant, policy-wise, is the internationalization of SMEs? Policies that have recently been rolled out in the US, EU and Korea all focus on identifying the potential of SMEs to enter overseas markets, boosting exports through market expansion, and creating more jobs by helping SMEs grow. As it is a general rule that SMEs do not account for a large share of a country's exports, there will be limitations to expanding national trade volumes by encouraging SME export activities. If, however, SMEs manage to widen their market and customer base by tapping into global markets, this will serve as an important foundation for future company growth. Normally, exporting companies tend to grow at a faster pace than non-exporting companies in terms of production and employment. If we take exporting companies in Korea as an example, they have been shown to graduate earlier from their 'small enterprise' phase to become mid-sized firms than non-exporting players.[2] Also, exporting companies have also been leading job creation in Korea for the past decade, and this observation also appeared to be true for the SME domain. In short, the higher number of SMEs entering overseas market leads to robust company growth, export expansion in the long term and job creation.[3]

Some notable changes have recently been taking place in the sphere of SME internationalization. To begin with, the steady growth of emerging nations since the 1990s has been opening up more market opportunities. The growth rate of exports from OECD to non-OECD countries during the period of 2000~2009 has recorded a yearly average of 10%,[4] and this is close to twice the growth rate of exports to OECD countries. Second, global value chains (GVCs) are playing a stronger role in international trade and investment. Worldwide, foreign added value is taking up an increasing share of exports, and SMEs are likely to be presented with more opportunities to join GVCs. Third and finally, companies that provide high value-

[1] WTO(2013), *World Trade Report 2013,* p. 85.
[2] Korea Chamber of Commerce & Industry, 2014 survey.
[3] It has been proven in general that FDI enhances the productivity of the relevant industry, but outcomes differ in research on FDI's impact on domestic employment. According to research undertaken by KIEP, FDI by Korean companies negatively affect domestic employment in the short term, but in the long run have a positive impact. (Hyun, Hea-Jung *et al.* (2010), *Korean MNEs and Domestic Economic Activity*. KIEP).
[4] OECD(2013), *Fostering SME's Participation in Global Markets,* p. 11.

added services will encounter more chances to enter global markets. The development of GVCs and rise in trade in tasks has caused an upward swing in the overseas procurement of services. As the investment market continues to open up, and international digital trade witnesses a sharp expansion, companies in the service sector are facing a turning point in internationalization.

In this context, supportive measures for SMEs venturing overseas should be designed from a fresh perspective. First of all, it is necessary to identify competitive SMEs and provide them with focused support for internationalization. According to existing research, SMEs engage in export activities because they have already secured a competitive advantage, rather than they become competitive by exporting. Such evidence implies that encouraging competitive SMEs to enter global markets should be a priority agenda. High value-added manufacturing and service firms especially play a pivotal role in GVCs; therefore, the government must be ready to support them in developing into exporting firms, working with global enterprises and strengthening innovative capabilities.

Second, SMEs must be able to benefit from lower trade costs. Amid relaxed tariff barriers and stronger GVCs, SMEs will respond more sensitively to trade costs incurred, for instance, by customs procedures compared to large enterprises. Thus, trade facilitation, technology standards harmonization and the swift application of preferential tariff rates under FTAs will impact SMEs' exports to a great extent. For example, in Korea, FTA benefits tend to be enjoyed less by SMEs than large enterprises,[5] which means that lowering the burden of complying with rules of origin requirements will help boost SME exports.

Third, SMEs require support in expanding and diversifying their target markets. In 2003 Korean SMEs mainly directed exports toward China, the US and Japan, but in 2013 the US and Japan accounted for less as export destinations while China took their place, accompanied by emerging nations like Vietnam and the Russian Federation. Meanwhile, FDI by Korean SMEs, which was formerly concentrated in the Asian region, is spreading out to Europe, North America and the Middle East. The key purpose of investment has also shifted from a complementary measure for exports to entry into target markets. To prepare for such changes the government should provide adequate, in-depth information on potential business partners and local market conditions of different countries, as well as reinforce support for SMEs using global networks on the government level. KIEP

[5] This is based on an unpublished report by this author(2014).