The integration of small and medium-sized enterprises into global value chain

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Abstract

Intensifying globalization of production and trade is causing growing competitive pressures for developing country producers. Accelerated technological advancements and trade and investment liberalization increasingly make fragmenting of activities in all stages of a production value chain possible. Some of these segmented activities can be performed in various locations across the globe and reintegrated again through production systems of global value chains and global production networks. A group of leading transnational corporations are playing a key role in organizing and controlling these production systems, benefiting from location differences in costs, infrastructure, capabilities in manufacturing, marketing and logistic, and in trade and investment regimes.

The objective of this research is to explain the role of global value chain in building and enhancing productive capacities of developing countries and economies in transition. By participating in a global value chain, domestic firms, particularly small and medium-scale enterprise (SMEs) can access technology, upgrade skills and improve their competitiveness. It can help developing country producers to enter foreign markets, earn more foreign currencies, diversify their exports, and most importantly to get new skills, knowledge and technology—all considered as key factors for productivity enhancement and growth.

I.

Reorganization and moving of the international business is the transformation of global economy having the important consequences for competitiveness of firms and prosperity of the nations.

Both Technological and managerial innovations and elimination of obstacles for a trans boundary flows of information, ideas, production factors and goods have led to occurrence of global value chain and associated production network

Though many large multi-national corporations continue to offer markets various products and services, all of them it is more and buy industrial resources and components from smaller firms in different geographic locations which serve concrete industrial niches more.

Transformation of the international business by means of genesis of global value chain creates possibilities for the new participants of international economy. As industrial systems become decentralized, fragmentary and more specialized, there are new market possibilities for all kinds of the companies, including the small and medium enterprises, for entering in the global markets, and moving to the export activity having higher value, at the expense of specialization. Many firms, particularly smaller enterprises, find out that it is possible to become successful and «value creations» at the expense of specialization in the limited range of activity, products and market niches.

However, use of advantage of such possibilities require, that the enterprises were capable to deliver the specified products in the necessary quantity, with the necessary quality, in due time, and meet an extending range of more and more strict standards. Return from participation in global value chain can be high, but those are also requirements are the same.

The successful participation of Georgian firms in global markets depends heavily on the capacity to innovate. Long-term profitability requires continuously improving a firm's performance to stay ahead of competitors through new products and processes, recombining activities, or exploring new markets. In this process, the economic networks in which a firm operates are key determinants of the profitable options that are open and the priorities a firm sets.

A useful concept for analyzing such networks is the value chain. It describes the full range of activities needed to bring a product or service from conception through the various production phases to consumers and final disposal after use. In such a chain, a firm will have a number of competitors, and as trade barriers fall, their number increases. Taking account of developments in the chain and the actions of its competitors, a firm can respond in various ways. The basic categories of upgrading are: process upgrading, product upgrading: functional upgrading; chain upgrading; chain integration.

The history of industry shows that there is something like a hierarchy of upgrading. From process upgrading it moves to product upgrading, with chain integration as the most complex form. Invariably, the share of knowledge-intensive activities increases along this trajectory. This has two important implications for producers in developing countries and countries in transition, especially in the small and medium-scale enterprise (SME) sector:

- Acquiring process capabilities is no longer difficult. As a result, competition in this area is heavy. By contrast, activities such as design, marketing, technology development and strategic repositioning are the most difficult to enter and offer the highest rates of return. To sustain growth, firms must be able to move up the hierarchy.
- Inputs of knowledge need not be firm-and/or location specific and are in many cases not very sensitive to scale economies. With global markets and electronic communication media, this opens up worldwide opportunities for SMEs with marketable knowledge in growth sectors.

In the developing countries and countries in transition, such as Georgia, SMEs play a key role for several reasons:

- The great majority of enterprises are SMEs and they are estimated to account for about three-fourths of employment.
- SMEs tend to promote a more equitable distribution of income than large enterprises because they are more
- labour-intensive and widely dispersed throughout the country, and support the development and diffusion of entrepreneurship. • SMEs contribute to an effective use of local resources, in particular through labour-intensive production methods.
- SMEs contribute to the establishment of dynamic and resilient economic systems in which small and large firms are interlinked.

The last point is very important for the successful participation of these economies in global markets. However, there tend to be few SMEs, which are capable of competing in a dynamic, globalizing economy, particularly in the least developed countries. Capacities for upgrading strategies that will allow such enterprises to exploit business opportunities in global markets, and take social and environmental issues into account, are often lacking.

This takes us back to the value chain. Transnational corporations are major drivers of innovation. In value chains, the relationship of SMEs to large enterprises varies from purely buying and selling to being a subsidiary of a large firm. From the point of view of upgrading independent SMEs, and the positive effects this has on the domestic economy, the most promising relationships are potentially those in which the large firm, having determined who is incorporated into the chain, sets standards and then helps the smaller firms to upgrade them to meet these standards. Apart from having the capacities for this purpose, more and more TNCs are helping supplier companies to adopt standards for social responsibility and environmental sustainability.

The type of value chain is a major determinant of development effects:

- In *buyer-driven chains,* large firms work with decentralized networks of independent suppliers, providing product specifications. Increasingly, the lead firm is a large retailer. This type is often found in labour-intensive consumer goods industries. Participation thresholds are relatively low, offering many opportunities for developing country producers capable of meeting the buyer's requirements (low-cost labour alone is not enough). The main short-term development effect is likely to be an increase in employment. But the lead firm can help to tackle social and environmental issues.
- In *producer-driven chains,* the lead firm, typically a large firm in a technology-intensive industry, tends to exercise much closer control over its suppliers. When these are not wholly owned, joint ventures are a common form of cooperation. Only the more advanced transitional economies and developing countries are likely to have the human and technical capacities needed by the lead firm, and the role of independent local producers will be more limited; but the technology and know-how transfer effects can be important. The automotive and electronics industries provide many examples.

These are two “polar” types, between which many levels of technological sophistication are found - also within industries. The markets served by the firms in a chain are another factor to be considered: advanced industries may pro- duce less sophisticated products for developing country markets, where labour-intensive, standardized technologies then present opportunities for local suppliers. Finally, company culture will be a determinant of relations between firms.

Even under the best conditions, partnerships will not improve the capacities of SMEs at short notice. The focus must be on the long-term learning effects which may help the SME sector to reach a level from where enterprises can graduate to sophisticated goods and services for world markets.

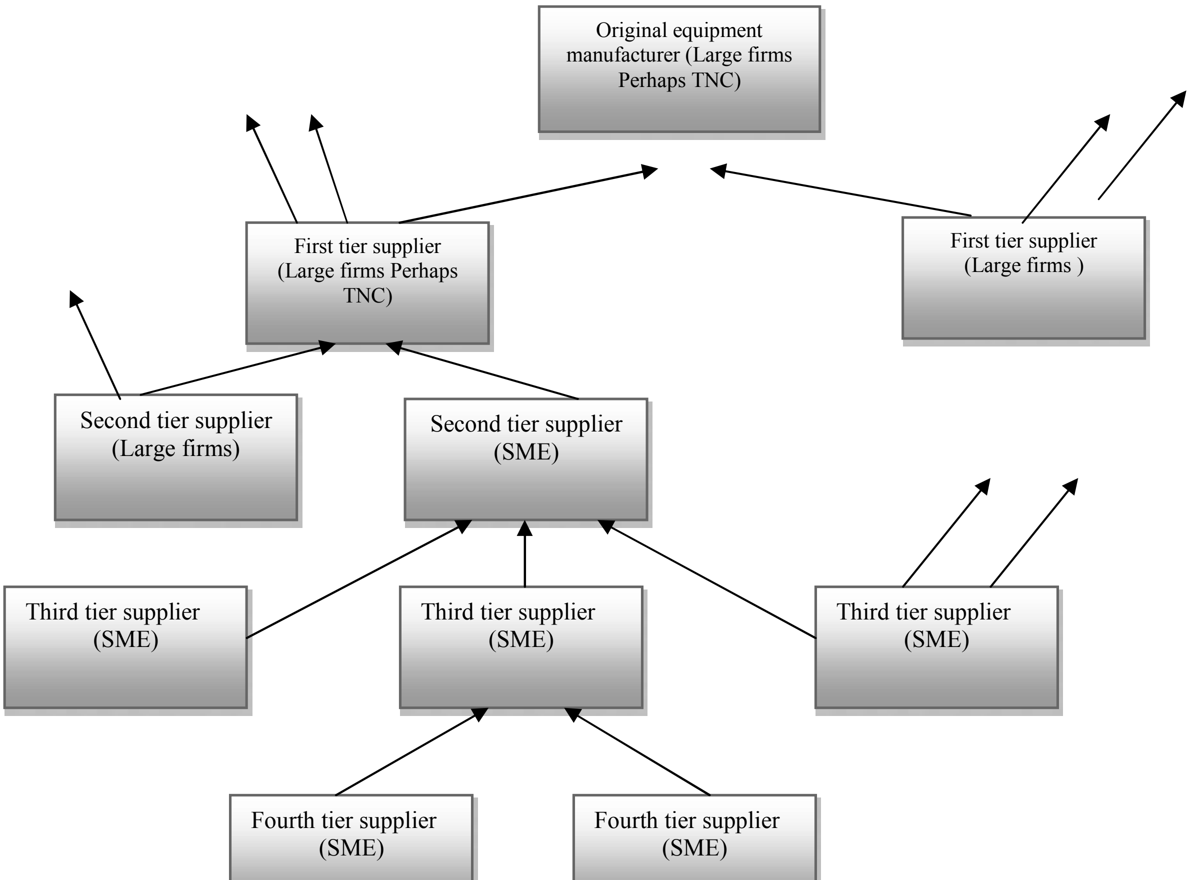
Although to integrate in global value chain it is necessary to create the advantageous environment that can attract investors, to support export diversification, that will be important for the formation of foreign sector. In this context are necessary two aspects: First labour-intensive production might attract foreign investment for preparing the intermediate product which will be used as resource of production in home country of investor. However to integrate in global value chain, labour cost on the product unit has to be lower and has to exist the possibility of inexpensive transportation. Both prerequisites partly exist in Georgia.

Second making investment in service sector can increase exports. This is evidence in the case of tourism.

How do SMEs fit into these value chains? The answer is that in general they do so as peripheral suppliers to one or more of the links in the chain, usually as second or third tier suppliers, as illustrated in figure 1. Occasionally SMEs may serve more than one customer, but in general they tend to be much more closely tied to single customers than do larger firms.

Integrating SMEs into global value chain

Figure 1



From the point of view of the SME, therefore, its future will generally be tied very closely to that of its customer(s), or in some cases its suppliers. On the other hand, its customer(s) may have a variety of suppliers, and there will be significant asymmetries both in their relative degrees of dependence and their relative degrees of economic power. At the same time, however, the customers of SMEs in these value chains will not be insensitive to the problems of their SME suppliers, since they may often produce critical components.

The value chain is only as competitive as its weakest link, more and more governors are putting resources into supply chain management, and then into supply chain learning. The focus of a sequential programme of supply chain development and supply chain learning best practice is shown, and it is to this which government policy has to relate. The major issues are:

1. *Wake-up call.* The key governing party in the chain has to recognize it has a problem in its own operations, which requires it to restructure in order to meet competitive pressures. This restructuring may either be proactive, in which case this chain is a first-mover, or it may be reactive.
2. *Internal change.* Having recognized the need to upgrade, the governor has to move to improve the chain's internal operations.
3. *Targeting value chain efficiency.* Having recognized the need to change the chain's internal operations, and having taken action to do so (since this is a necessary precursor to supply chain management), the governor needs to recognize the need for its own value chain to become more effective. It also needs to recognize that this value chain improvement must extend beyond the first tier, and that the SME suppliers in its chain may have particular problems.
4. *Rationalization of vendor/customer base.* Almost always the first step, which the governor will need to take, will be to rationalize its supply or customer base. Although this may lead to a reduction in the number of first tier suppliers, insofar as the role played by SMEs in its chain is concerned, it need only ensure that its first or second tier suppliers are capable themselves of upgrading their SME third and fourth tier suppliers.
5. *Monitoring and sanctioning new performance by suppliers.* Supplier performance then has to be measured. Where deficient, suppliers need to be negatively sanctioned, and this may or may not be complemented by positive rewards to those suppliers who perform well.

There is increasing recognition of the role which effective governors can play in improving the performance of their supply chain, including that of SMEs. This applies equally to low, middle and high income countries. At best most firms recognize the need for supply chain efficiency and are systematic about communicating their requirements to their suppliers. In a few cases they will take active steps to assist their suppliers' upgrading, but this seldom exists beyond the first tier. Some reports suggest that the Japanese keiretsu system works effectively with regard to SME upgrading. This is a system whereby first tier suppliers take responsibility for cascading improvements right through their supply chains. But some scepticism is warranted even in this case.

This weak performance on supply chain upgrading represents both a threat and opportunity for public sector support institutions. Incorporation in global value chains as third and fourth tier suppliers is probably one of the most effective ways of ensuring that SMEs participate gainfully in the global economy. But for this to happen, these SMEs will have to learn to meet the demands of world class manufacturing—low and falling costs, high and rising quality, and flexible and reliable deliveries. Although some isolated cases exist in which value chain governors take an active lead in promoting and assisting SME upgrading, the reality is that the motivating force for upgrading will have to come either from the SME sector itself, or from targeted policies by government and international organizations.

It is here that the policy circle is squared. That is, policies designed to promote the gainful incorporation of SMEs in global product markets through general industrial support, or through programmes designed to promote networked upgrading, are a necessary complement to the larger task of assisting SMEs to upgrade so that they can play a more effective role in governed global value chains.

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