Chapter 1

INTRODUCTION

Over the past two decades trade and investment have been the driving forces in accelerating economic growth in South Asia. In the recent decade South Asian countries have increased export competitiveness and foreign direct investment inflows. As a result, new business opportunities have opened up for domestic enterprises. Despite their tremendous potential, SMEs[1] in South Asia are still at a disadvantage due to a lack of essential business factors such as capital, profitability, managerial skills, trained labour, brands and networking. Although SMEs account for more than 90 per cent of all private enterprises and employ roughly 60 per cent of the domestic workforce in South Asia, relative share of SMEs production in total domestic output is much smaller, approximately 35 per cent, as is the direct contribution of SMEs to merchandise export earnings, which is around 25 per cent (AAMO 2007).

Broad-based inclusive and sustainable growth with the active involvement of the private sector is one of the most important development strategies in poverty reduction opted by many developing countries, including those in South Asia. To attain this goal, export-oriented SMEs and supporting industries should be recognized for the important role they play in their respective national economies. However, to become successful SMEs should be promoted and supported by not isolated and half-hearted measures but concerted and coordinated policies and institutional efforts. In smaller economies with limited domestic markets, high economic growth and rapid socio-economic transformation can be achieved through export growth, and SMEs, showing

[1] Having recognized their expected contribution to industrialization in developing countries in Asia and the Pacific, this study mainly focused on the development of export-oriented SMEs as well as SMEs in supporting industry, including micro enterprises. Those SME segments are typically characterized by high technology adaptation and backward linkage, which are key success factors for their effective participation in global and regional value chains (Uchikawa and Keola 2009). Other major SME segments, namely domestic market-oriented SMEs and cottage industry, which serve domestic and local markets, were not discussed extensively in this study although they may share some of similar corporate characteristics to export-oriented and supporting industry SMEs. Note that the statistics of SMEs in this study are the aggregate data of all SME segments at the regional, subregional and national levels.

tremendous potential in that respect, should be supported at both regional and global levels.[2]

Within this context, one of the most important challenges facing SMEs in South Asia is creating new business opportunities, targeting the foreign markets. Establishing effective linkages with global and regional markets, including those of major emerging economies in Asia and the Pacific, such as China and India, is a major challenge for SMEs. However, recent experiences from a wide range of countries in Asia and the Pacific do indicate that SMEs could access international markets through global (and regional) value chains (GVCs). They could build efficient networks by establishing linkages with large enterprises or even with other SMEs. Such integration in GVCs are expected to help boost SMEs' value added activities in international trade, in which SMEs, at present, play a limited role due to a lack of proper networking. In particular, the proposed shift would immediately help smaller economies in South Asia, such as Bangladesh, Nepal and Sri Lanka, in accelerating their socio-economic development and poverty reduction.

It should also be noted that the emergence of GVCs has intensified competition in value added activities and required continuous skill development. Such competition could lead to greater economic and development disparities in South Asia at both the company and country levels, unless national policymakers in cooperation with business practitioners and international development agencies create a business environment for the succesful integration of SMEs in GVCs.

Addressing key policy issues for export-driven SMEs in South Asian developing countries, the Trade and Investment Division of ESCAP devised a project to explore new ways and means and provide effective tools for SMEs integration into global and regional markets through participation in global and regional value chains.

The introduction presents all four key topics. The first section discusses research framework, including value chain analysis, research objectives and methodology. The second section reviews the existing SME development approaches of different donor agencies, while the third section briefly describes the recent key developments in the business community in Asia and the Pacific, particularly the emergence of global and regional value chains. The final section explains the overall structure of the publication.

1.1. Research framework

The study was conducted as part of ESCAP initiatives on Business for Development, a comprehensive programme for private sector development in Asia and the Pacific. It was designed as a pilot project adapting value chain analysis to addressing possible areas of policy interventions for strengthening export- led SME development strategy in South Asia. The next section of the chapter provides a brief outline of the value chain analysis.

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[2] While reviewing the prospects for SMEs it should be noted that there are a number of bilateral and multilateral agencies involved in developing the private sector in South Asia (e.g., ADB 2000; GTZ 2010; JICA 2006; UNDP 2007; UNIDO 2010; USAID 2010; and World Bank 2002), which often focus on SME development.

Bangladesh, Nepal, and Sri Lanka were included in the study. Based on the outcomes and findings of the study, other technical assistance projects might follow to help policymakers' capacity-building in South Asia and other subregions in Asia and the Pacific with the objective of making SMEs an integral part of global and regional value chains. The study emphasized issues affecting women and youth entrepreneurs, who play an important role in the SME sector in all countries of the ESCAP region.

1.1.1. VALUE CHAIN ANALYSIS: A DIAGNOSTIC TOOL

Value chain analysis has been defined by Michael Porter as a diagnostic tool that disaggregates a firm into its strategically relevant activities in order to understand the behavior of costs and existing and potential sources of differentiation (Porter 1985). He claims that value chain analysis allows us to diagnose the competitive advantage of a firm or industry and to enhance the advantage by tailoring the value chains. However, there have been significant developments since Porter introduced the concept and the broader approach to value chains includes the complex range of activities implemented by various actors (suppliers, primary producers, processors, traders, service providers, etc.), transforming raw material into the final product and delivering it to retail market. The broad value chain starts at the production stage and moves along the linkages between enterprises engaged in trading, assembling, processing, etc. The wide approach includes not only the activities implemented by a single enterprise but also all the activities of its backward and forward linkages up until the stage at which the raw material, turned into the final product, is linked to the final consumer (Roldan-Prez et al. 2009).

Value chain analysis or commodity chain analysis disaggregates the global structure of fabrication, trade and consumption of commodities and allows for the identification of factors and geographical divisions (Tuvhag 2008). Value chain analysis has been widely adopted by researchers, industry and development practitioners to understand the political economy of contemporary global production systems and has also served as a tool to analyze different aspects of chain coordination and governance.

At the most basic level, value chain analysis systematically maps the actors participating in the production, distribution, marketing and sale of a particular product. While this mapping may be a valuable exercise, it is rather descriptive and, as such, is more of a heuristic device (Kaplinsky and Morris 2001). However, according to Kaplinsky and Morris (2001), by adding and focusing on three key components, such as (a) barriers to entry and rent, (b) governance and (c) value chain type, the value chain approach becomes a powerful analytical diagnostic tool.

The barriers to entry and rent concern the identification and distribution of benefits to different actors in the chain. It also means that through a value chain one can determine who benefits from the participation in the chain and from the government interventions and support.

The governance of the value chain refers to relationship and coordination mechanisms that exist between its various actors. As Schmitz (2005) points out, there is often a powerful lead firm in the chain that wishes to control and govern the relationships. The question then is: what is the lead firm's motivation to assume such a dominant role in the value chain? The answer to the question is in product definition. Firstly, the lead firm needs its suppliers to understand certain product specifications in great detail and ensure compliance in order to successfully pursue a strategy based on e.g. product differentiation. Secondly, while suppliers are facing steadily increasing performance and quality standards, controlling the value chain decreases the lead firm's own risk of encountering supplier failure (Schmitz 2005).

The third component of the value chain analysis suggests distinguishing between buyer- and producer-driven chains. Kaplinsky and Morris (2001) link the first type to labour intensive industries and deem it very important for developing nations. In producer-driven value chains, a number of key producers have critical resources, such as technology, at their disposal as well as the ability to coordinate the links in the value chain (Kaplinsky and Morris 2001). Furthermore, this type of value chains seems to attract a higher number of foreign direct investment and employs a different kind of production system (Gerefffi 1999b). In general, while the third component of the value chain analysis might not yet be fully explored, it is very valuable as it stimulates the generation of helpful analytical questions (Kaplinsky and Morris 2001).

Value chain analysis was applied in each of the individual country studies in order to assess the selected sectors or products from the respective countries. Particular emphasis was placed on export promotion and linkages to global markets. Based upon the result of the analysis, national action plans, aimed at improving SMEs business environment, were developed. Objectives and expected outcomes are elaborated upon in the subsequent section.

1.1.2. OBJECTIVES AND EXPECTED OUTCOMES OF THE STUDY

The major objective of the study was to assist South Asian countries, namely Bangladesh, Nepal, and Sri Lanka, in developing national action plans for the improvement of their business environments to facilitate SMEs access to regional and global markets, especially through GVCs. Subregional constraints and opportunities in the development of export-oriented SMEs in these three countries were analyzed, resulting in the development of a comprehensive action programme. Specific objectives of the study included: (a) identifying sectors (or products) with a high export potential; (b) evaluating the processes and relationships from the value chain perspective by developing sectors/products best suited for export promotion; (c) reviewing policy and regulatory framework affecting selected sectors and products; (d) identifying constraints for broadening the prospects for the development of effective sector/product value chains for SMEs involvement; and (e) preparing and finalizing national action plans and a subregional action programme for stakeholders' further interventions.

1.1.3. METHODOLOGY

The project included three national studies and a synthesis summary. The work intended bringing out: (a) potentialities for enhancing value added; (b) national action plans; and (c) a subregional action programme for addressing economic cooperation issues in South Asia. Consequently, the study presented an analytical review of existing policy measures, acts, documents, studies, and other materials on SMEs.

As the project also aimed at addressing participating countries' policy frameworks, institutional arrangements, public-private sector cooperation mechanisms and technical support, additional primary data collection, adopting qualitative research methods, such as semi-structured interviews, site/field visits and observations, focus group discussions and other feedback communications, has been conducted to include the views and participation of all stakeholders. To support the collaboration and improve the overall quality of the study, research teams were established at the national level for each target country by inviting academics, industry experts and/or researchers.

The project activities included: (a) preparing three country research papers on national GVC issues; (b) organizing national workshops on reviewing the country papers and considering the feasibility of national action plans; (c) preparing a synthesis summary of the three country papers, which included a strategic framework and a subregional action programme; and (d) organizing subregional workshops finalizing national action plans and the subregional action programme.

1.2. SMEs development approach and key focus areas

Before shifting the focus to the emergence of global and regional value chains, it is worthwhile to highlight the strategic importance of SMEs in the overall economic development and bring out the role of various development and donor agencies in this context. There are six key focus areas for SMEs that deserve particular attention as they determine SMEs business environment and capability to successfully tap into global markets and access the global value chain.

The crucial role of SMEs in economic development has been widely recognized in the past and became even more evident recently with SMEs fostering job creation, generating incomes, improving performance and competitiveness and contributing to the economies of both developed and developing countries.

Therefore, various agencies have designed and implemented SMEs development interventions in Asia and the Pacific, particularly in South Asia. The strategic approach of 13 major bilateral and multilateral development and donor agencies was reviewed in terms of its focus and modalities. It was determined that specific and detailed interventions, improving the SME sector value added and strengthening its contribution to respective economies, should concentrate on six key issues:

1. Enabling policy and regulatory environment, including introducing effective institutional framework and pro-business fiscal policy;
2. Supporting SMEs business infrastructure;
3. Promoting entrepreneurship, developing managerial skills and human resources;
4. Improving access to financing;

5. Developing and adapting technology; and
6. Developing SMEs business services.

The findings indicate that a comprehensive SME development approach typically includes all or some of the above-mentioned six key areas for detailed intervention. The key factors are presented below.

(1) Enabling policy and regulatory environment

A transparent policy and regulatory environment ensures enterprise facilitation for the establishment, operation, promulgation, access to resources and markets and exit. To a greater extent the sustainability of policy and regulations – such as enterprise registration, corporate governance, fiscal incentives, anti-corruption and labor laws – relies on efficient administrative framework. Efficient policy and regulatory directives, with adequate implementation and operation modalities, would result in building confidence among SMEs entrepreneurs and strengthen their capacity to improve linkages with other enterprises. The availability of specialized and formal institutional resources for SME development is the foundation for creating a level playing field and facilitating their access to finance, skills and knowledge. It must also be noted that availability of SME-related public services would also be a strong support in furthering SME development.

(2) Supporting SME business infrastructure

The basic physical and organizational infrastructure includes, among other things, transportation, water supply and sewerage, power grids, telecommunications and research and training facilities. Quality business infrastructure facilitates the production of goods and services and enhances competitiveness. A number of bilateral and multilateral donors are supporting South Asian countries in building such infrastructure. However, SME specific infrastructure is still insufficient, particularly in the areas of skills development and in providing physical facilities, such as training institutions and SME parks. Supporting SME targeted infrastructure would enhance the productivity of SMEs and improve their competitiveness in international markets.

(3) Promoting entrepreneurial culture

This study defined entrepreneurial culture as a tendency in the society to promote or motivate people to become entrepreneurs. Government provisions helping and supporting entrepreneurs, including developing their technical skills, play a vital role and should become an integral part of entrepreneurship building. An extensive programme for entrepreneurial development, with concomitant support through small business consulting services, would also result in an enterprise setting-up and strengthening. Policy measures, such as entrepreneurship training and education, youth entrepreneurial programmes, new business incubation as well as women entrepreneurship development would stimulate the entrepreneurial culture. Increased donor support would be a significant help in such areas.

(4) Improving access to financing

Improving access to financing means enhancing the degree to which financial services become available to all, through easy and affordable means. The ability of SMEs to grow and strengthen their competitiveness over time largely depends on their ability to invest in restructuring, innovation, improvement and diversification. All these investments require both short- and long-term capital and, therefore, access to financing is very important for them. One of the consistently repeated complaints from SMEs has been the lack of access to finance (cf., AMMO 2007; ESCAP 2009). In attempting to gain access to financial services, SMEs are faced with constraints caused by many factors, such as financial sector ineffectiveness, lack of information on financing availability, lack of collaterals, poor property rights laws and. lack of financial products. Policymakers need to address these issues to make financial resources accessible to small entrepreneurs. Interventions by governments and other regulatory institutions should include: microfinance; commercial loans; public credit guarantees; and SME specialized financial institutions. However, very few donors have directly assisted in these areas. Donor assistance in financing SMEs through business incubation programmes and targeted financing, particularly in rural areas, could bring concrete results.

(5) Developing and adapting technology

One of the critical factors influencing the competitiveness of enterprises is technological capability for quality products and services. Technology is comprised of both the "hardware" of physical assets, and the "software" of know-how and skills. Technology development and adaptation include research and development (R and D), dissemination of information and knowledge, matching technology with current needs and creative adaptation of technologies for new uses. SMEs in developing countries very often produce products and services of moderate quality mostly due to the adaptation of outdated technologies and this has resulted in rejection of their products in competitive markets at both domestic and international levels. In recent years the situation has worsened, because SMEs in developing countries had to survive the intense competition of globalization, where countries had to adapt their trade regimes and phase out of tariff barriers under the World Trade Organization mandate. The best use of technology, no doubt, enables SMEs to reducing cost of production, maintaining consistency in quality and standardization, improving productivity and finally enhancing their competitiveness. The growing interest of Governments in introducing technology policies and bringing up institutional and infrustructural changes is necessary to boost the competitive dimension. However, donor assistance in technological capability building has been rather limited. This is particularly true of SMEs in South Asian countries. Building-up technology related institutions, strengthening R and D facilities and increasing assistance in widening skills development programmes could bring tangible gains in improving SMEs competitiveness both in domestic and international markets.

(6) Developing SMEs business services

Inadequate business development (and support) services or their relatively high cost has hampered SMEs' efforts in improving their competitiveness as service providers, particularly lawyers, accountants, business consultants and technical consultants do not provide cost effective management solutions required for SMEs. Furthermore, lack of information and accessibility to utilize existing services by SMEs has also resulted in weak demand for such facilities. Obtaining information on commercial law, taxation, customs regulation, market intelligence, business advisory services, training opportunities and financing sources is generally expensive and time consuming; thus, most of the SMEs, particularly in South Asian countries are unable to avail themselves of those provisions. It is therefore most desirable that governments should take the lead in promoting such critical SME development services jointly with business and industry associations. Donors particularly can assist by providing financial assistance and sharing in successful business experience coming from other countries, including professional certificate schemes for service providers.

The six key areas for SME development, where donors' assistance is provided, require further strengthening. With active involvement of all stakeholders, particularly SME associations, chambers of commerce and industry as well as governments soliciting large donor assistance, a supportive environment can be fostered for SME development. This is particularly important, as the emergence of global value chains poses new challenges but also provides opportunities for SMEs.

1.3. The emergence of global and regional value chains

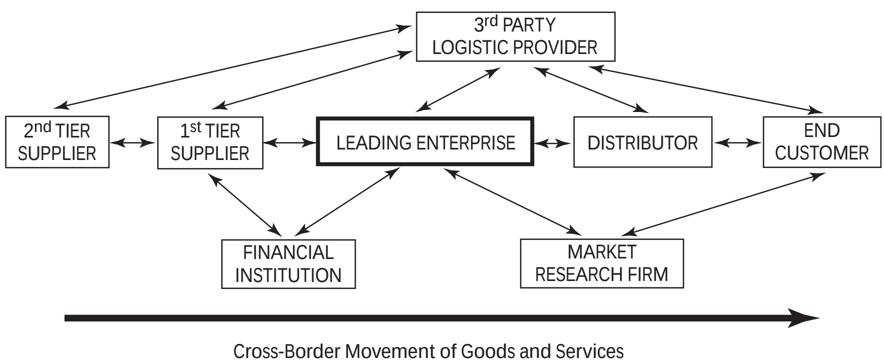
One significant development in the Asia-Pacific business sector has been the emergence of global and regional supply or value chains.[3] A global value chain refers to the full range of cross-border value added business activities, which are required to bring a product or service from its conception through design, sourcing raw materials and intermediate inputs, production, marketing, distribution and support to the final consumer (ESCAP 2007). The rise of these global value chains is the result of two interdependent and complementary dynamics: reorganization and relocation. While the first involves business decisions about what core competencies the enterprise needs to retain and which functions it could outsource, the latter one is about offshoring, i.e. moving the firm's entire or partial operations to another country (ESCAP 2007). Furthermore, global value chains have also grown as a result of some key developments, accompanying the globalization process, and the emergence of international production networks. Such developments include trade and investment liberalization, the development of low-cost and fast logistics systems and ICT applications that enable products and services, including semi-processed outputs, to quickly and efficiently move across the world.

[3] For further details, see United Nations, *Globalization of Production and the Competitiveness of Small and Medium-sized Enterprises in Asia and the Pacific: Trends and Prospects.* Sales No.E.09.II.F.23; United Nations., *Asia-Pacific Trade and Investment Report 2009:Trade-led Recovery and Beyond.* Sales No.E.09.II.F.19; United Nations, *Linking Greater Mekong Subregion Enterprises to International Markets: The Role of Global Value Chains, International Production Networks and Enterprise Clusters,* Sales No.E.07.II.F.2.

The emergence of global value chains is characterized by increased concentration of production and distribution, smaller numbers of tougher competitors and independent suppliers and the potential for taking advantage of complementary comparative advantages among enterprises or economies involved in the value chain. Thereby, the global value chains have spread to various industrial sectors, such as automotive, electronic, food and apparel/garment sectors in the region (ESCAP 2007).

A number of enterprises, including SMEs, participate in global value chains, providing services within their expertise and often collaborating with foreign investors through joint ventures, strategic alliances and other partnerships. The enterprises include, among others, suppliers, distributors and business service providers (e.g., third-party logistics providers, financial institutions and market research firms). Value chains are normally coordinated by a leading enterprise, typically a transnational corporation (TNC), which possesses power through control of business factors, such as: brand recognition, indigenous knowledge and technology, production assets, distribution channels and control over critical inputs (see Figure 1). Since the end of the 1980s, TNCs have invested in the Asia-Pacific region setting up their value chains and building on national export-oriented development strategies matched with the increasing global demands.

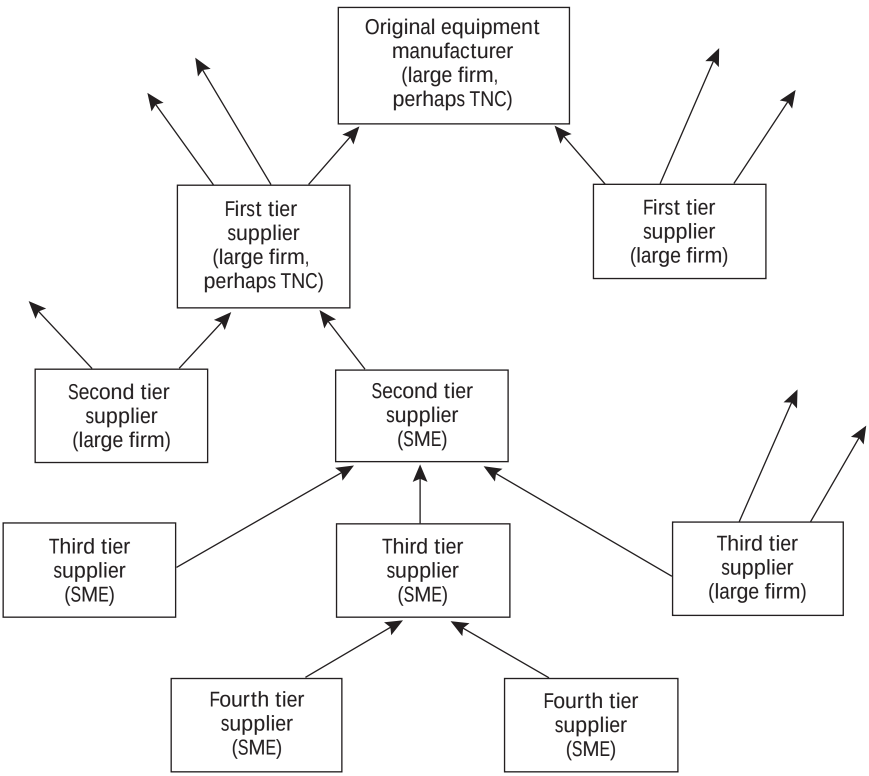
Figure 1: A simplified global or regional value chain



Source: ESCAP (2007).

Global value chains have changed the traditional mode of competition among enterprises that was based on low costs and prices although these factors are continuously important in business-to-business relationships. The new competition is no longer taking place among individual enterprises but rather among global or regional value chains, based on the efficiency of their entire production and distribution networks. Such competition now depends on a wider range of determinants in both export and domestic markets, such as brand power, the capacity to meet a variety of stringent global product and process standards, the level of flexibility and rate of innovation, the speed of design and extent of differentiation, the degree of reliability and level of timeliness and the extent and quality of networks with both horizontally and vertically linked enterprises.[4] Although many Asian and Pacific enterprises have participated in various global value chains, only a small number of them, mainly in East and North-East Asia, actually control the value chains as leading enterprises; the majority of participating enterprises, typically SMEs, are minor members within the value chains (ESCAP 2009a). As previously mentioned, a transnational corporation usually assumes the role of the lead firm in the global value chain. This lead firm is supported by numerous smaller enterprises, which are categorized as higher and lower tier suppliers of inputs. The higher the tier, the more value is added by the supplying enterprise and thus, the SMEs in the lower tier category contribute rather simple outputs and add less value (ESCAP 2007).

Figure 2: How do SMEs fit into global value chains



Source: United Nations Industrial Development Organization, *Integrating SMEs in Global Value Chains. Towards Partnership for Development*, 2001, p. 60.

[4] See also World Bank,and IFC. *Doing Business 2011: Making a Difference for Entrepreneurs.* Washington, D.C.: IBRD, 2010.

While the development of global and regional value chains in Asia and the Pacific has provided unprecedented business opportunities to export-oriented SMEs and its supporting industry, including those in South Asia, they are facing the challenge of tier mobility. Ideally, SMEs would access the global value chain in the capacity of a higher tier supplier, as the lower tiers are characterized by unstable conditions and one SME could be easily replaced by another. Alternatively, if direct access to a higher tier is not possible, it would be important for the SMEs to have the chance to move up in the global value chain and become a provider of higher value (ESCAP 2007).

The emergence of global value chains emphasized the need for a new technical assistance programme on SME development, particularly in South Asia. Having recognized greatly diversified economic status and conditions, as well as different natural endowments among the countries of that subregion, the one-size-tailored approach may not be workable with all participating countries. However, value chain analysis, with a special emphasis on trans-border issues and a focus on specific sectors and products can effectively address the six key success factors, identified earlier in the chapter. This was done in various sector studies undertaken under the present project in the three participating countries: Bangladesh, Nepal and Sri Lanka.

1.4. Structure of the publication

The publication is comprised of four research studies – three national studies on Bangladesh, Nepal and Sri Lanka, found in the annex and a synthesis of these studies. Chapter 1 identifies the need for the global value chain analysis, giving specific examples of technical cooperation between selected donor partners and SMEs in these countries. Chapter 2 presents the background information related to the three countries' selected products; the synthesis, summarizing the major points and findings of the national studies; and a proposed subregional action plan that includes measures and tools, enhancing South Asian SMEs' integration in global and regional markets. Chapter 3 concludes the publication providing the direction for research and technical assistance activities in South Asia.

The national study on Bangladesh in Annex I is focused on consumer and industrial plastic product sector, while Annex II covers agro-based industry, particularly coffee and ginger products sectors in Nepal. Annex III covers two industrial sectors in Sri Lanka, namely industrial rubber and electronic goods. The national studies offer action plans for various stakeholders in their respective countries to improve business environment for promoting export-oriented SMEs.