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Columbia FDI Perspectives
Perspectives on topical foreign direct investment issues
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No. 365 September 4, 2023

How can governments help small enterprises integrate into global value chains?

by
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A 1% increase in global value chain (GVC) participation is estimated to boost per capita income by more than 1%, compared to 0.2% income gain from standard trade. Two distinct attributes of GVCs—hyper-specialization and enduring firm-to-firm relationships—make participating enterprises more productive and higher profit earners. For example, Ethiopian firms integrated in GVCs are more than twice as productive as those engaged in standard trade. It is thus imperative for micro, small and medium-size enterprises (MSMEs) to go global to build and sustain their long-term competitive advantage.

MSMEs can partake in GVCs through supply-chain linkages via trade, by directly importing inputs and exporting outputs; via FDI, by supplying to, or sourcing from, domestic affiliates of foreign MNEs; or linking-up with foreign MNEs indirectly through established, large domestic firms. This *Perspective* offers policy recommendations to leverage the FDI route to deepen the integration of host country MSMEs into GVCs.

MSMEs face multiple hurdles to internationalizing: the informal status of many of them; susceptibility to exogenous shocks; and lack of skills, technology, capital, and financing. MSMEs also find it onerous to comply with investment regulations. However, due to hyper-specialization underpinning GVCs, MSMEs can relax some of the constraints by focusing on the production of intermediate goods and services where they have a comparative advantage. A study found that a typical US MNE sources 25% of its total inputs from more than 6,000 MSMEs.

Integration with GVCs fosters durable MNE-MSME linkages that promote the diffusion of technology and knowhow. A 2018 survey of 1,476 apparel, textile and ICT firms in Ethiopia and Vietnam found that firms with strong linkages were 38% more likely to receive assistance than those without strong MNE relationships. MSMEs can thus move up the value chain while learning-by-exporting and importing. In Kenya, South Africa and Uganda, global supermarket chains have helped their MSME suppliers to improve horticulture processes to fulfill demand for higher quality products and sustainable sourcing standards, resulting in higher export yields as local suppliers moved up the value chains.

In GVCs, affiliates of foreign MNEs support their domestic MSME suppliers—they become more productive as a result. Costa Rican firms exemplify this: after beginning to supply MNEs, Costa Rican firms experienced a 6-9% gain in productivity within four years due to FDI spillovers. In sub-Saharan African countries, geographical proximity of domestic firms with foreign affiliates explains up to 30% of productivity gains. Survey evidence from Thailand supports the centrality of holding internationally recognized quality certifications for integration into GVCs. More generally, MSMEs gain managerial skills, the capacity to innovate, acquire new technologies, and reduce costs—all of which also benefits host countries by strengthening domestic enterprises.

However, not all MSMEs can successfully link-up with GVCs. Those with adequate capabilities need to be identified, while those that are almost linkage-ready need to be helped. An example is the Czech Republic's Supplier Development Programme in the electronics and automotive sectors: it offered targeted need-based training to over 50 identified MSMEs, enabling their participation in sectoral GVCs.

MNE-MSME linkages alone do not suffice. Host country policies related to trade, investment and the absorptive capacity of domestic firms have a profound impact on the extent to which linkages materialize and result in enhanced MSME participation in GVCs.

Some policy recommendations to enhance FDI-induced host country MSME participation in GVCs are:

- Encourage the adoption of digital tools by MSMEs, as these reduce their information constraints. MSMEs with a digital presence in the form of a webpage have a higher chance to become exporters. Government e-Marketplace in India has catalyzed the adoption of digital technologies by including MSMEs in public procurement.

- Facilitate the international certification of MSMEs, to improve their absorptive capacity for spillovers from FDI and foster MNE linkages. The Zero Defect Zero Effect Certification initiative of India's government helps MSMEs to transform into international leaders, by strengthening national certification and testing capacity to ensure compliance with international standards.

- Conceive a business matching program to deepen linkages. Singapore and Thailand have successfully embedded MSMEs in GVCs following this strategy.

- Adopt policies to attract FDI from first-tier MNE suppliers, to facilitate indirect access to GVCs. Since 2012, Samsung has developed such an ecosystem in the electronics sector in Vietnam. By 2020, first-tier Vietnamese suppliers increased more than tenfold, to 50.

- Provide incentives to MSMEs to upgrade their capacities to stay competitive and remain integrated in GVCs. For example, the subsidies provided by the Economic Development Board of Singapore to allow local MSMEs to temporarily employ engineers from foreign MNEs has facilitated technology transfer, deepened linkages and embedded local firms in GVCs.

- Facilitate access to credit through matching grants and loan guarantees to boost MSME financing—a significant hurdle in GVC participation. In Germany, Bürgschaftsbanken constitute a network of 17 guarantee banks that fund roughly a third of all MSME loans.

FDI can cause substantial changes in the export structure of host economies through higher GVC participation. MSMEs can play an important role in this process, but governments need to adopt clear and targeted policies and support mechanisms that enable these firms to become linkage ready.

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