Assessing Opportunities for Growth in Developing Countries of Micro, Small, and Medium-Size Enterprises

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Executive Summary

- The density of micro, small, and medium-size enterprises (MSMEs) is a good indication of positive or negative changes that are occurring in an economy, as high and upper-middle-income countries have a greater proportion of these types of enterprises than do low-income countries.
- Value chains are widely considered to be the main engine for MSME growth in developing countries, because they can provide access to markets and technology, encourage business linkages, facilitate the upgrading of skills, and create links with international companies.
- Value chains should not, however, be viewed as a panacea for MSME development, as linkages to large companies are easily broken during periods of sluggish growth and market contractions, and, more generally, MSMEs are often unable to integrate into large-scale business relationships because they lack international standards, and quality controls.
- Business development service (BDS) centers have proven successful in upgrading MSMEs, and facilitating their entry into value chains. As such, they should become an integral part of the MSME development process; the challenge is to make BDS centers self-sustainable. A model that combines a cost-sharing facility (CSF) with a credit guarantee facility (CGF) can provide a means of ensuring that sustainability.

Introduction

The predominance of micro, small and medium-size enterprises (MSMEs) in the business activities of countries generally reflects the magnitude of growth, employment, competition, and poverty within those countries. The density of MSMEs, measuring their number per 1,000 persons, is greater in high-income countries such as the United States and members of the European Union than in middle- and low-income countries such as Malaysia and Bangladesh (Figure 1). The same relationship exists between microenterprises and income levels: high and upper-middle-income countries have a greater proportion of these types of enterprises than do low-income countries. The density of MSMEs is, therefore, a good indication of positive or negative changes that are occurring in an economy.

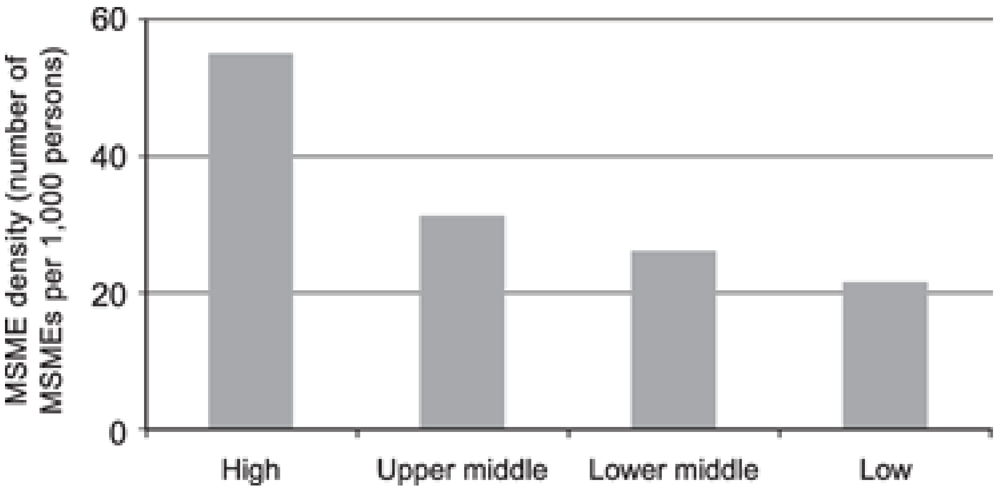

Figure 1. MSME density in country income groups. (*Source*: Derived from data in International Finance Corporation (IFC), World Bank Group, MSME database online)

Note: MSME density refers to the number of MSMEs per 1,000 persons in a country.

From an economic policy perspective, development of MSMEs can be a means of promoting growth and development in a country, although the causal direction is not always clear: in some cases, the MSME sector can be the driving force behind economic growth and poverty reduction, as it was in some Asian newly industrialized economies (NIEs, or "Tigers") during the "Asian Miracle" of the 1980s, while in others it follows the growth of export-oriented large enterprises. In nearly all cases, however, large foreign and domestic enterprises have played a key central role in the growth process, with MSMEs linked closely to them as downstream suppliers, and subcontracting between MSMEs providing business linkages that have enhanced sector efficiency, and productivity. In the current global financial crisis, increasing attention is now being paid to the role of value chains in promoting growth, innovation, and cross-border investments as a means of efficiently exploiting existing MSME capacities to renew growth in the emerging economies of Asia, Latin America, and Eastern Europe.

Defining Micro, Small, and Medium-Size Enterprises (MSMEs)

There is no single standard for defining the size of MSMEs. Most countries use the following definitions based on the number of employees:

- **Microenterprises**: 1–9 employees
- **Small-size enterprises**: 10–49 employees
- **Medium-size enterprises**: 50–199 employees

Note: The greatest variation in definition occurs in the upper end of medium-size enterprises, and can range from 99 to 499 employees.

MSMEs and Global Value Chains

Value chains are widely considered to be the main engine for MSME growth in developing countries. They can provide those enterprises with access to markets and technology, encourage business linkages, facilitate the upgrading of skills, and create links with international companies. By integrating their activities into international chains of production at various stages of added value, MSMEs can reap the potential benefits of global trade.

With the growth of regional trade arrangements among developing and transition economies, value chains have the added advantage of geographic proximity of MSME linkages to large companies in neighboring countries, as distance is one of the most stable determinants of successful value-chain relationships. In that sense, buyer–supplier relationships in cross-border value chains are replacing cross-border trade based on market-determined transactions. The changing regional and international context, and the growing role of value chains in production and trade suggest that much of the potential growth for MSMEs is situated in or around integrated cross-border production systems.

The experience of developing and transition economies, however, shows that value chains are not, in and of themselves, a panacea for MSME development. First, MSME-related value-chain activities in some countries have flourished during periods of rapid national and international market growth, but linkages to large companies have been broken during periods of sluggish growth and market contractions. During periods of cyclical or structural downturns, large companies cut costs by downsizing business activities through cuts in personnel and elimination of suppliers, a process that is often unplanned and unorganized. The role of MSMEs is then to become a buffer for absorbing unemployed workers from large firms, and prepare new entrepreneurs for eventual graduation into large firms when the economy recovers.

Secondly, under the current global financial crisis, many companies are tightening their supply chains. Countries are adopting strategies to mitigate supply-chain risks by adopting performance-based contracts with suppliers or service providers, establishing closer collaborative relations with trading partners, developing multi-sourcing strategies, and using redundant suppliers. Closer collaborative relations are now reflected in increased near-shore sourcing and manufacturing activities, as companies favor regions such as Eastern and Central Europe over China, and other East Asian countries. The situation is compounded in many countries by weakening export growth and softening industrial production, as well as falling prices for high-value-added products in agriculture.

Finally, MSMEs are often unable to integrate into large-scale business relationships because they lack international standards and quality controls. Most of these enterprises operate without any type of certification, which greatly reduces their prospects of developing backward linkages with large enterprises. Their ability to develop domestic and international commercial activities by improving quality standards through, for example, the adoption of just-in-time management systems is equally limited, and often requires both the adoption of best business practices within firms, and support from outside sources such as business organizations, large company affiliates, and the public sector. These best business practices are outlined in the next section.

Best Practices for Promoting Business Linkages

Good business practices for MSME linkages to large enterprises are generally recognized to follow established guidelines:

- Improve products and services of local suppliers, through technology transfer and skills upgrading that give local suppliers the ability to meet international production and quality standards. Access to product-related technology and design specifications can help suppliers meet specifications of international standards.
- Implement policy initiatives that promote an enabling environment for the private sector, emphasizing taxation, infrastructure, red tape reduction, intellectual property protection, competition policy, finance, and measures that impact on the overall competitiveness of an economy.
- Strengthen the supply capacity of local MSMEs in different fields, ranging from technical skills in production processes to management competences. Business support services can conduct training sessions with suppliers and distributors on quality control, international standards in producing for exports, and methods to improve management practices.
- Improve access to finance and non-financial business services with specialized competencies in different fields. The section that follows discusses ways to foster special credit facilities and advance payment mechanisms in support of MSMEs, by linking those facilities to business support services, and providing guarantees for suppliers taking out loans from banks.
- Promote development of industrial clusters that generate economies of scale and agglomeration, which can help to develop a network of firms cooperating in complementary areas of specialization. One way to promote those clusters is by promoting their local presence, through cluster-focused subcontracting promotion programs that diffuse information on infrastructure and financial facilities. The programs can be combined with international seminars to attract potential foreign and domestic suppliers.

Upgrading MSMEs for Better Business Linkages

Business development service (BDS) centers have proven successful in upgrading MSMEs in a way that facilitates their entry into value chains. These centers provide a wide range of services covering management and vocational skill training, consultancy and advisery services, marketing assistance, access to information, technology development and transfer, and business linkage promotion, that allow enterprises to take advantage of value chains.

Financing these services has, however, proven difficult as many businesses are unable or unwilling to pay for the services, with the result that BDS centers go out of business within a few years. Moreover, because the medium and upper range of small businesses is more capable of paying for these services, business consultants usually target those enterprises rather than micro and small enterprises. As a result, the largest and most important sector of these enterprises do not benefit from the services.

One successful BDS model uses a mix of commercial business consultants and private, commercial, and public institution assistance to develop a system that supports these centers by combining a cost-sharing facility (CSF) with a credit guarantee facility (CGF). The challenge is to make BDS centers self-sustaining within a period of, for example, five to seven years from their inception. The CSF is a fund, normally managed by the BDS center, that provides matching grants to businesses using the BDS services. To overcome the resistance of small businesses in paying for the services, the business portion of the cost is taken from a part of a loan offered to the businesses. Those loans are supported through a credit guarantee facility that selectively backs loan applications by MSMEs to commercial banks. The financial guarantee agency is normally represented by a commercial insurance company acting as a guarantor to the borrowers.

Examples of the application of this model range from a multi-pronged SME development project in India, supported by a US$120 million loan by the World Bank, to similar projects in Bhutan and the Maldives, financed by the Asian Development Bank (ADB), and a Danish-funded SME development project for the agricultural sector in Tanzania. In all these cases, BDS centers are being created with the combined use of CSFs and CGFs, to ensure the sustainability of SME development and financial services. Under these mechanisms, a direct relationship is created between the guarantor and the borrower, as the former needs to assess loan applications, and selects the ones to be guaranteed. This process reduces the probability of moral hazard on the part of the commercial bank during the screening process. While other BDS models may be more appropriate for some particular sector or country, this model is being successfully implemented in a number of Asian countries. Whatever the form of the BDS service, it is important to recognize that its success will depend on a mix of both MSMEs and large enterprises, commercial BDS and companies, financial institutions, and public and donor-assisted interventions.

Case Study

Coffee in Laos is grown by small producers or stakeholders in the southern part of the country. Production is mostly organic, as the cost of fertilizers is outside their reach, and infrastructure and access to transportation limits their access to agricultural inputs. Despite its high quality, Laotian coffee farmers have been unable to take advantage of their organic product for several reasons:

1. without extension services, farmers have poor on-farm technical skills, and poor post-harvest handling, all contributing to low yield, poor quality control, poor product quality, and limited volume of a marketable product;
2. lack of marketing facilities prevents them from linking with key buyers in the international coffee market;
3. branding of Laotian coffee has not occurred;
4. the Coffee Growers Association of Laos lacks the capacity to promote its organic coffee and reap higher prices.

Existing constraints have also given rise to a number of weaknesses in the supply-chain process:

1. high formal and unofficial transaction costs;
2. lack of organization among producers;
3. weak linkages between Laotian exporters and international markets, due to the widespread use of coffee traders;
4. dominance of one company in the supply chain;
5. lack of organizational capacity among the main coffee actors;
6. dominance of the Coffee Growers Association over all coffee-exporting activities.

A recent Asian Development Bank team working on an agricultural sector loan identified supply-chain opportunities for Laotian coffee farmers with Doi Tung Development Corporation in Thailand. Doi Tung is now exploring ways to establish supply-chain systems that promote market-oriented transactions, and ensure involvement of producers in all stages of coffee processing (especially for arabica-type coffee). They are also working with Laotian producers to create coffee post-harvest facilities, and improve export delivery facilities to lower the price penalty currently applied to Laotian coffee because of the unreliability of deliveries.

As part of these developments, efforts are being made in the following areas:

- Financing public investment on extension services and rural infrastructure that will improve physical infrastructure to facilitate access to agricultural inputs, and reduce the cost of transporting coffee from farm to processing location and markets.
- Improving market information systems to reduce spread between producer and market prices, as well as strengthening market distribution channels for accessing agricultural inputs, and ensuring producers' quality requirements are met for particular markets.
- Establishing mechanisms for determining quality standards as well as grading, classification, and quality grading, to differentiate product pricing.
- Enhancing investment financing mechanisms and export credit guarantee facilities.

Conclusion

The focus of MSMEs has shifted from the development paradigm targeting niche markets, to one directed at the establishment of member networks operating along a value chain. Developing and transition economies offer access to mineral and agricultural resources, as well as low-cost labor. Likewise, the development of clusters of competitive suppliers in Latin America has made it possible for domestic suppliers of automotive parts and components in Argentina and Brazil, and electronics components in Mexico to become first-tier suppliers in global value chains.

But the value-chain model should not be viewed as a panacea for MSME development. Not only are linkages to large companies easily broken during periods of sluggish growth and market contractions, but MSMEs are often unable to integrate into large-scale business relationships because they lack international standards and quality controls. The rewards of such a business model are only likely to be gained by those enterprises that are able and willing to take the necessary steps to establish sustainable business linkages. For suppliers, it means adopting specific policies to attract foreign direct investment, building their capacity to upgrade their skills and competitiveness, and taking proactive measures to improve their capacity to supply the market. For large local firms or multinationals, it means creating available information and opportunities for business linkages, organizing trade fairs, participating in business-matching events, and developing outreach programs to MSMEs that support BDS services as a means of establishing business linkages.

Making It Happen

For MSMEs in developing countries, the establishment of business linkages with large local or transnational companies offers a way to access international markets, finance, technology, management skills, and specialized knowledge. Key actions for creating those linkages include the following:

- Identifying the gap between the supply capacity of the local enterprise, and the requirements of large companies, or foreign affiliates;
- Strengthening supply capabilities by developing skills in different fields, ranging from technical skills in production processes to management competencies that focus on technical and managerial skills;
- Gaining access to networks of suppliers by locating in industrial parks and special economic zones, or, where size limits access, through industrial complexes specifically geared towards smaller enterprises;
- Improving access to non-financial business services through BDS centers, as well as financial services, by participating in credit guarantee facilities;
- Promoting public-private partnership programs that support an enabling environment for business linkages, especially in countries where market systems are still in their infancy;
- Networking with other suppliers to create a critical mass of enterprises for backward linkages to occur, especially able to link up with several large companies, rather than relying on a single one that may break relations during market downswings, or periods of sluggish growth.

More Info

Articles:

- Ayyagari, Meghana, Thorsten Beck, and Asli Demirgüç-Kunt. “Small and medium enterprises across the globe.” World Bank, March 2005.
- Mugione, Fiorina. “Good practices and policy options in the promotion of TNC-SME business linkages”. Trade and Development Board Commission on Enterprise, Business Facilitation and Development Expert Meeting on Best Practices and Policy Options in the Promotion of SME-TNC Linkages. Geneva, November 6–8, 2006.
- UNCTAD Secretariat. “Developing business linkages.” Trade and Development Board, Commission on Enterprise, Business Facilitation and Development, Expert Meeting on Best Practices and Policy Options in the Promotion of SME-TNC Business Linkages. Geneva, November 6–8, 2006.

Websites:

- Comprehensive database on micro, small, and medium-size enterprises: http://rru.worldbank.org/Documents/other/MSMEdatabase/msme_database.htm
- Doing business database for countries: www.doingbusiness.org

See Also

Best Practice

- Assessing Opportunities for Growth in Small and Medium Enterprises
- Globalization and Regional Business Strategy
- Toward a Total Global Strategy
- Value Creation—Perspectives and Implications
- What Entrepreneurs and Small Business Owners Can Do to Increase Their Chances of Success in the Global Economy

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