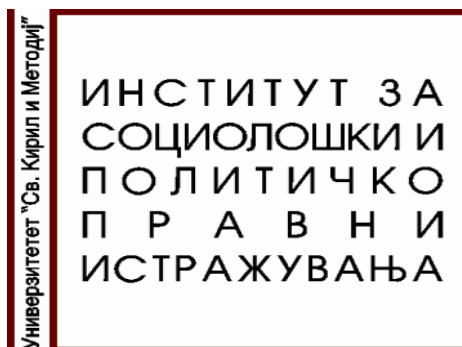


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Institute for sociological, political and juridical research



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International conference

CHALLENGES OF CONTEMPORARY SOCIETY

12 November 2015,

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Importance of Exchange Rate for SMEs Improvement and Economic Development

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Abstract:

Progressive globalization has created a new international environment for SME exports from developing countries. The process of world economic integration has involved a broadening and deepening of inter-relationships between international trade and foreign investment flows. Several influences – falling trade barriers, increasing technological progress, migration of technical and professional manpower and highly mobile multinational corporations (MNCs) seeking out new investments – have combined to drive globalization. The end result has been the creation of an international marketplace for goods and services that seems indifferent to national borders and state regulation.

In January 2014, Macedonian government published a Programme for the Support and Development of SMEs. The Programme identifies three policy areas of major importance for SMEs:

- internationalisation;
- the reduction of administrative burdens, especially as regards licensing procedures; and
- improved access for financing micro-firms.

The aim of this paper is analyzing and giving recommendations which are necessary for small and medium enterprises to make efforts in economic development as to contribute in a way that they will make the promotion of domestic products, have organized a joint presentation on external markets, will exhibit initiatives for creation of distribution centers. In this regard, the entry of FDI in manufacturing and real exchange rate are expected to contribute for exporters in the production of high quality and distinctive products, which would lead to higher absolute prices, higher productivity and lower unit labor costs of products.

Key words: SMEs, exchange rate, development, strategy

INTRODUCTION

SMEs are an important source of export revenues in developing economies. An interesting observation is that SMEs contribute a larger share of manufactured exports and support the intuitive understanding that medium-sized enterprises have higher export potential than small enterprises with up to 50 employees (Ayyagari, Beck, and Demirgüç-Kunt, 2003). This means that policies for the promotion of SME export potential and SME exports must be targeted.

SMEs contribute to employment and income generation as export revenues too. However, in order to tap into the potential of SMEs for development and poverty reduction, transition and developing country governments, development partners and SMEs themselves need to address a number of challenges. This underlines the essential meaning of a) creation of new and innovative firms and graduation of as many informal enterprises as possible into the formal sector, b) SMEs have to become more competitive and productive at their home base and c) SMEs have to achieve a level of competitiveness that will enable them to integrate into the global value chains through trade (exports and internationalization) and investment, including linkages with FDI (Badrinath et al., 1997). These challenges become more complex as globalization proceeds because globalization has the potential to open up access to new markets, technologies, skills and capital for SMEs. If we connect this with the effort of economic integration than it will bring a striking increase in competition from imports, the entry of new foreign investors and the strengthening of domestic, large firms that start to take over traditional, mostly local SME markets.

1. SMES, CHALLENGES AND COMPETITIVENESS

Challenges for SMEs development are multi-dimensional. As trade barriers, transport and communication costs fall, SMEs are required to add more value to their products to stay ahead and compete with lower cost rivals. Consumer demand is changing rapidly as incomes rise and choices increase when imported products become easily available in domestic markets. Technological advances create new products and transform almost every stage of business from production to marketing, sourcing and logistics. New rules introduced through

the multilateral trade system and foreign buyers require SMEs to comply with higher technical, environmental and labor standards in domestic and export markets. Multinational enterprises seeking out new markets and investments offer capable SMEs the opportunity to insert themselves into global value chains through subcontracting linkages, while those that are unable to do so increasingly face the danger of losing their existing markets. Competition within the developing world for export markets, foreign investment and resources is also intensifying.

According this, Metcalf, Ramlogan and Uyarra (2003) argue that competitiveness is embodied in the characteristics of the firm:

- the current efficiency and effectiveness of the use of resources,
- the willingness and the ability to relate profitability to growth of capacity (i.e. the willingness to invest), and
- the ability to innovate to improve technology and organization and thus improve efficiency and effectiveness.

So this means that competitive advantage is determined by how efficient and effective the prevailing markets for products, labor and capital are. Also here must be created business strategy which will include:

- to know what the consumer want and what is the market
- to think of creating new product
- to be always available
- to cooperate with other firms
- pro-actively upgrade.

The last one - pro-active upgrading is also very important and this take a lot of effort because of product design capability, improving measurement, standards, quality and productivity, recruiting qualified staff and training, forging sub-contracting links with other firms, making use of technology institutions and other business services and actively seeking foreign buyers and marketing agents (Wignaraja, 2003). SME development strategies will necessarily be country specific. Each country will have its own challenges, opportunities and priorities for change. Resources available for implementation will vary by country, so that results achieved will also be different.

Notwithstanding such specificity, past and present experiences and practices of developed countries offer a menu of lessons and best practices for transition and developing countries. SME development lessons seem to hold true, independent of region and level of development among countries (UNCTAD, 2001):

- Peace and stability is a key requirement for the development of SMEs and for attracting foreign investment.
- SME development requires a crosscutting strategy, (i.e. its success depends on the ability of governments to implement sound macroeconomic policies, the capability of stakeholders to develop conducive microeconomic business environments, and the ability of SMEs to implement competitive operating practices and business strategies).
- Dialogue and partnerships between the stakeholders is essential
- Investments in physical infrastructure and business services and the implementation capacity of policy makers, local level administrators and support structures determine success. Continued dialogue and partnerships between stakeholders into implementation and review of supportive measures, particularly, those related to capacity building in institutions at all levels, yields improved outcomes.

2. OPPORTUNITIES FROM SMEs INTERNATIONALISATION

Internationalisation has become increasingly important to the competitiveness of enterprises of all sizes. In today's environment, SMEs that start with a global strategy can move quickly to take advantage of cross-border activities, which provide opportunities not only for revenue growth but also for the exchange of knowledge and the enhancement of capabilities, thereby strengthening the long-term competitiveness of the firm. Despite the common understanding of the importance of internationalisation, there are still many internal and external barriers that impede the internationalisation of SMEs. Moreover there is a lack of data on the actual export performance of SMEs and the challenges and issues they face.

It is important to note that while the prospects for SME success are tied with macroeconomic developments, they by no means identically mirror all of them. As the majority of SMEs

operate in sectors that serve domestic demand, for example, they did not share in the benefits of increased foreign demand, which was the key macroeconomic driver of growth from 2008 to 2013. Many SMEs are not in export-oriented sectors, particularly the micro and small enterprises. Thus, programmes supporting SME exports benefit directly only a sub-set of SMEs. However, indirectly, all SMEs benefit to some extent as higher exports raises:

a) overall income levels, and hence the demand for goods and services sold by domestic demand facing SMEs, and

b) the demand for goods and services originating from exporting-oriented enterprises.

In an increasingly internationalised world, there are competitive advantages for those businesses that begin with a global strategy and can move quickly to take advantage of cross-border activities. Providing further, tailored support for this growing asset class would form a key step in allowing SMEs to leverage the benefits of increased foreign demand for goods and services.

Looking ahead, there is a positive outlook and the promise of a strengthening of the recovery on the horizon. Total value added generated by SMEs has already surpassed its pre-crisis level and now it is expected to rise (from 2.8% in 2014 to) 3.4% in 2015 (ACCA, 2012a). Improvements in EU SME's performance depend critically on the further evolution of the macro-economic recovery. However, specific measures for improving the SMEs business environment play an important enabling role to ensure that SMEs are able to reap the full benefits of a return to solid and sustainable macroeconomic growth. However, international activities are mostly geared towards other countries inside the internal market and only about 13% of EU SMEs are active in markets outside the EU. The results showed that export-oriented SMEs show higher growth of turnover and employment than SMEs catering for the domestic market (Wignaraja, 2003). In addition, export oriented SMEs are also more innovative. So, it is in the public interest to support the internationalization of the SMEs.

Why is important to support greater internationalisation? Could be mentioned several reason (Tas, 2002):

international SMEs create more jobs

1. international SMEs are more innovative
2. public support goes largely un-noticed

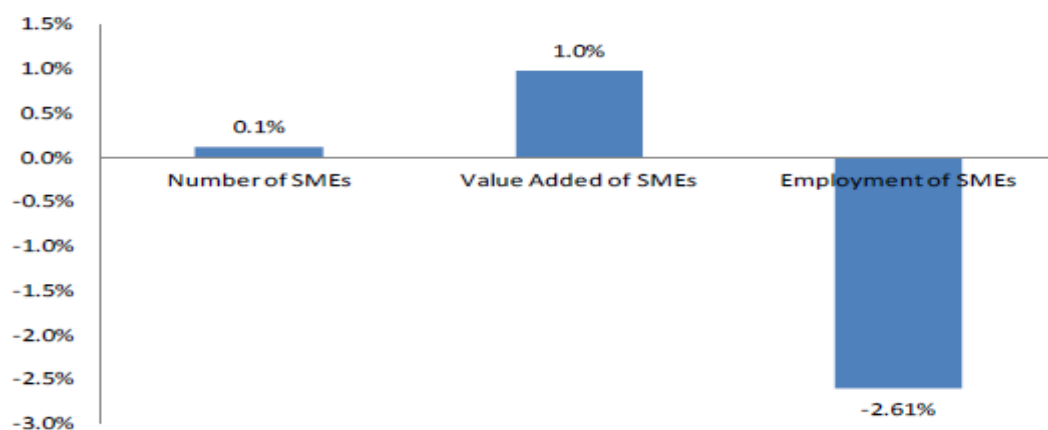
3. European SMEs are more internationally active than US and Japanese SMEs. Overall, European firms are more active than their counterparts in Japan or the US. Even if only extra EU exports are considered they still perform better;
4. most often SMEs start international activities by importing.

The opportunities from the internalization of SMEs are better connecting European SMEs to international markets, and specific measures to facilitate the access of European SMEs to these markets. The clear policy implication is that, while any measures to stimulate exports by SMEs may benefit only a limited number of SMEs, their increase in export activity will eventually benefit all SMEs, including those active in very low or low exportintensity industries. However, the overall gains are more limited for the SMEs active in low-export industries than for the SMEs active in industries with a higher propensity to export.

3. ECONOMIC CRISIS AND SMES RECOVERY

At the EU level, SMEs have recovered to pre-crisis levels only in terms of value added, and to a lesser extent, in terms of number of firms. Employment in 2013 was still 2.6% below levels registered in 2008 and the note is the fact that the relative importance of SMEs and large enterprises in the non-financial business sector is practically unchanged since 2008 (Figure 1).

Figure 1.Recovery of EU28 SMEs in 2013 relative to 2008 (% change in 2013 levels from 2008 levels)

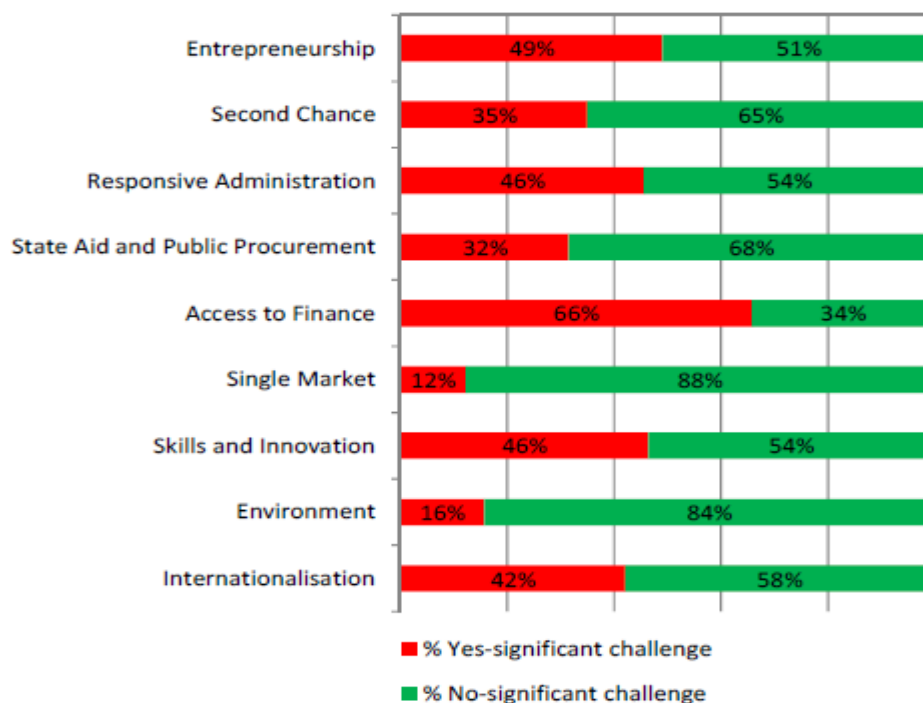


Source: Eurostat, National Statistical Offices and DIW Econ

A survey conducted for measurement the SME performances show particular challenges as most significant (Figure 2) (White and Chacaltana, 2002):

- ✓ under Access to finance, the difficulty in accessing to bank credits or loans and the excessive bureaucratic procedures to access EU funds were identified as the main barriers.
- ✓ concerning Entrepreneurship, the lack of financial support measures was the main underlying barrier which also correlates to the access to finance.
- ✓ for the Responsive administration, the administrative burden was pointed out, and more specifically the difficulty in managing all of the administrative requirements and requests from various authorities.
- ✓ finally, issues related to the Skills and innovation principle focused on the lack of strategic support in converting an innovative idea into a commercial product/process/service.

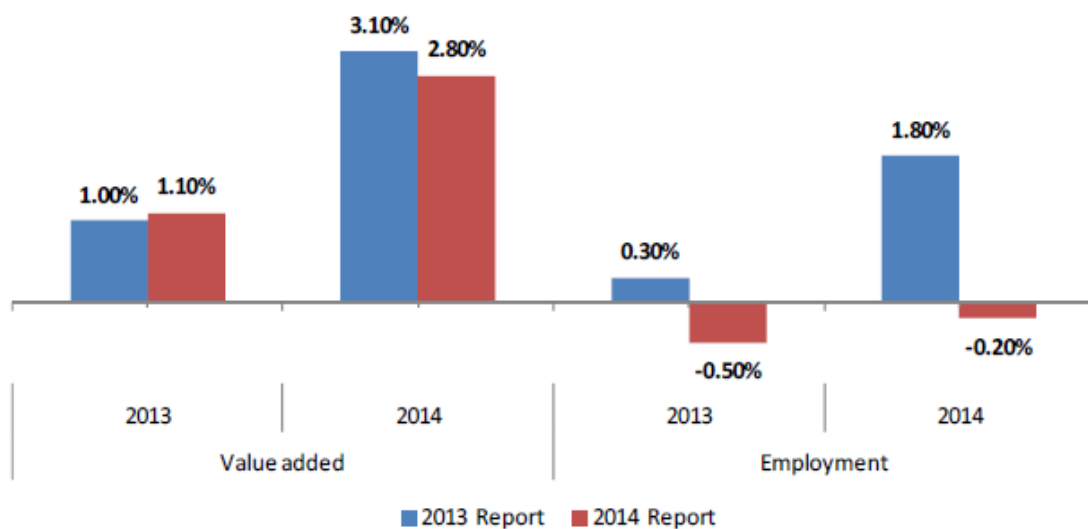
Figure 2: Most challenging principles to SMEs at national level – EU28



Source: White&Chacaltana, 2002.

SME performance forecast for 2015 showed that total value added generated by SMEs in the EU28 has returned above its pre-crisis level and is expected to continue to rise by another two percentage points by 2015, expanding by 2.8% and 3.4% in 2015. Employment in EU28 SMEs is also expected to increase, growing by 0.7% in 2015. Moreover, the number of SMEs is predicted to increase by 0.38% in 2015. All three groups of SMEs are predicted to expand in 2015, with micro SMEs expected to grow somewhat less rapidly than small and medium-size SMEs. The estimate of annual growth in SME value added in 2013 and 2014 are little changed from the forecasts shown in the 2013 report (Figure 3). This reflects the fact that firms, large and small, focus much more than previously expected on improving their productivity.

Figure 3: 2013 and 2014 estimates of performance of SME sector in EU28



Source: Eurostat, 2014

4. SUPPORTING SME EXPORT DEVELOPMENT AND THE ROLE OF EXCHANGE RATE

At the macroeconomic level, government policies and the ability to stabilize a competitive real exchange rate is the cornerstone of promoting exports. A competitive real exchange rate provides an incentive for exports. Moreover, an outward oriented, market-

friendly trade regime, which emphasizes the dismantling of import controls and tariffs, and streamlined bureaucratic procedures, *i.e.* export and import procedures, modern customs administration and efficient value added tax administration will facilitate exports, including from SMEs.

The impact of exchange rates on trade in a given country, as in Macedonia, example for small and open economy, should be seen in the context of continued integration of supply chains. Exports, generally, include high import content and impact of foreign currency-exchange appreciation or depreciation on any finished product because it is complex. If the depreciation of the exchange rate makes its exports of finished products "cheaper", it makes imported components "expensive" for domestic producers. Maintaining growth and reducing the unemployment in a small and open economy such as Macedonia depends from improved performance of exports. Improving the performance of exports can also help to preserve macroeconomic stability by closing the gap in the current account to avoid wasting supplies and to stop the growth of external debt. Improving performance requires improving export competitiveness. In the short term, competition may be related to the level of the real exchange rate, which provides internal and external balance. The appreciation of the real exchange rate with respect to its equilibrium level reduces the incentives and the ability of manufacturers to compete in foreign markets, since a significant part of production costs paid in local currency. In the long run, real exchange rates are assumed to converge to its equilibrium level, and competitiveness is more related to the productivity of the economy. So, firm-level strategies are fundamental to development of exports by an SME. Wignaraja (2003) suggests that globalization opens up new opportunities for export expansion and growth to about 5-10% of SMEs in developing economies (Wignaraja, 2003). These dynamic SMEs have designed well-adapted marketing strategies and invested in their manufacturing capabilities to bring them up to world standards of price, quality and delivery. Experience of exporting SMEs from developing countries illustrates the fact that they have pro-actively upgraded themselves (Srinivasan and Archana, 2011).

However, accomplishment of a pro-active upgrading menu, requires easy and cost-effective access to information on consumer demand and new technologies, training and advisory services to upgrade management practices, a skilled pool of labor in the country to select from, testing, quality assurance and certification institutions, and most importantly access to finance to upgrade technologies. Technical assistance in the areas of quality management, productivity improvement and metrology is needed to help SMEs comply with the product

standards and regulations applied in export markets. In developing countries, particularly the less developed ones, technical advisory and consultancy services are scarce due to low levels of investment in developing engineering skills. Although management consultancies are emerging, the affordability of such services, especially for potential exporters are quite questionable.

Appropriate measures to maintain and to further improve the competitiveness of exporting SMEs and to draw additional SMEs into exporting might include grants for SMEs to obtain accreditation facilities, establishing productivity and design centers to upgrade SME design to international standards; and assisting SME membership organizations. Access to SME trade finance at competitive interest rates can be strengthened through export credit guarantee schemes for SMEs; and subcontracting and specialist soft loans for SME export activities. In many cases, the domestic and regional markets tend to provide a stepping stone from which SMEs can learn important lessons concerning product quality, timely deliveries and managing risk involved in international business. Where there is an inadequate domestic market, or the products are only attractive for export, considerable effort needs to be put into strategic positioning and reliable production so as to reduce risk of failure. Such effort is obviously costly and requires capacity building of SMEs and export development institutions, including sectoral membership organizations (Hudson et al., 2001).

Developing and transition economy governments do have an option to confront the challenge of improving export competitiveness of their SMEs. This may be achieved by developing a national strategy for export development and promotion. The overall objective should increase the volume and value of exports and the number of exporting companies, including SMEs. The strategy should seek to address the needs of firms at different stages of export market development. It should also seek to integrate export support and promotion into a well developed and effective business support system.

4.1. Exports and investments drive growth in Macedonia for 2014/2015

Macedonian output growth accelerated in 2014, driven by exports of foreign investors and public infrastructure investment.¹ Solid gains in household spending further bolstered domestic demand. Given high investment- and trade-related import demand, the foreign balance weighed down on economic activity. Further gains in domestic demand are likely to

¹ http://www.nbrm.mk/WBStorage/Files/WebBuilder_FSR_2014.pdf

set GDP growth at an even higher pace in 2015 and 2016, while the negative contribution from net exports is expected to diminish.²The government remains supportive, with plans for further infrastructure projects, and increases in entitlement spending, relaxing its mid-term fiscal consolidation strategy.

Large-scale public infrastructure projects and a surge in exports, mainly driven by foreign companies established in the country, carried the marked acceleration of real GDP growth in 2014.³ Given the high import content of investment and exports, the external balance made a negative contribution to growth, after having been its main support in 2013. Strong increases in overall gross fixed capital formation in the first three quarters of 2014 were followed by slack towards the end of the year, yet, on average, investment activity recovered markedly after its sharp drop in the preceding year. As of the second quarter, household spending, supported by rising real net wages, stable private transfer inflows and improved access to credit, turned into a solid second pillar of domestic demand growth. The merchandise trade balance improved in 2014, in terms of GDP, compared to the previous year. In combination with an increased surplus in the services balance, and stable private transfer inflows, accounted for a narrowing in the current account deficit, by 0.5 pps. to 1.3% of GDP. Job creation in the manufacturing sector, bolstered by active labour market measures, was the main driver of further, though decelerated employment growth, and a further decline in the unemployment rate.

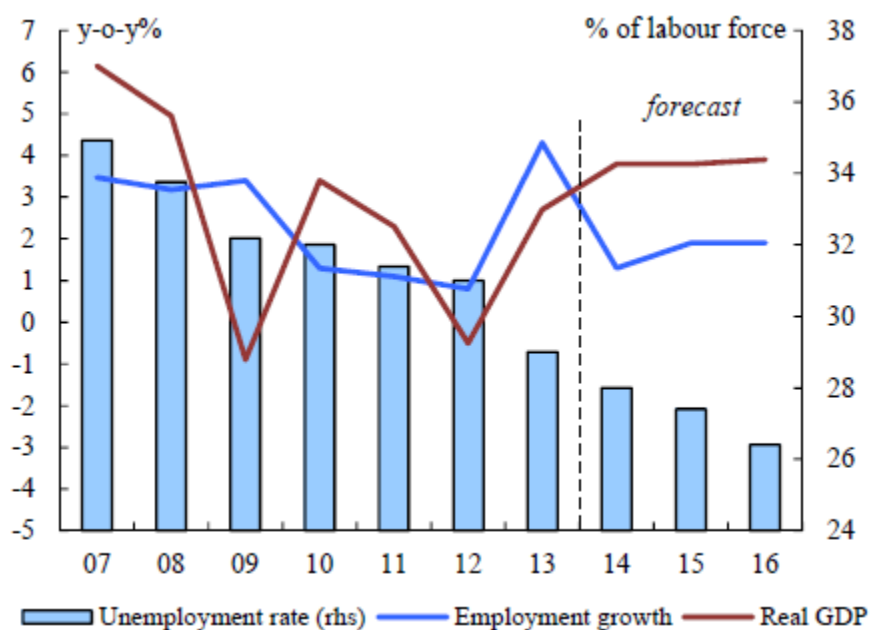
Fiscal performance disappointed further in the second half of 2014.⁴ The government supported private demand by a further rise in public wages in the autumn. At the end of the year, the general government deficit amounted to 4.2% of GDP, exceeding the revised target by 0.5 pps. The increase in government debt remained contained in 2014, but borrowing by state-owned enterprises drove up public debt levels as well as contingent liabilities of the government, which provides guarantees for their loans.

² http://www.nbrm.mk/WBStorage/Files/WebBuilder_FSR_2014.pdf

³ NBRM (2014) *Recent Macroeconomic Indicators*, Review of the Current Situation.

⁴ NBRM (2014) *Recent Macroeconomic Indicators*, Review of the Current Situation.

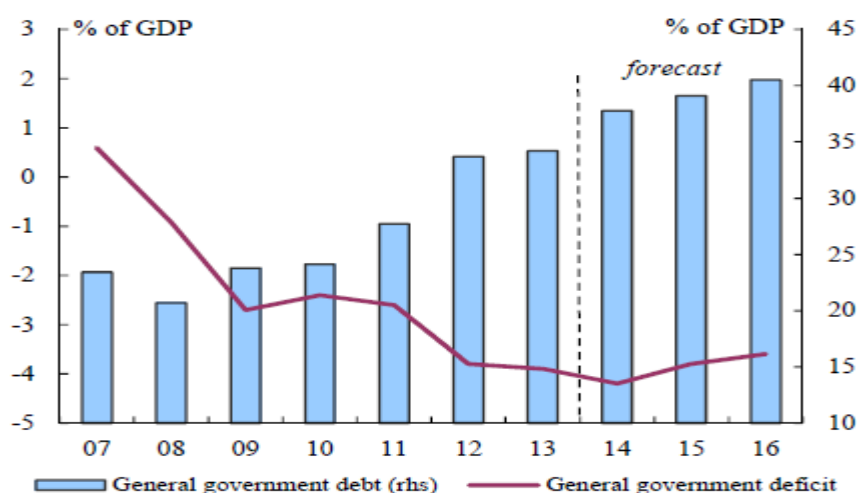
Graph 1. Macedonian Labour market



Domestic demand is expected to remain the sole growth driver over the forecast horizon. Investment activity, driven by public expenditure on transport and energy projects, as well as the construction of new foreign investment facilities, is projected to post further solid gains, even though growth rates are slowing down to their long-term average. Household spending, benefitting from sound fundamentals, is likely to firm up further, and set to become the main source of output growth in 2015 and 2016.

Export performance is projected to remain solid, mainly driven by foreign exporters which are putting new production lines in operation. With investment-related imports relenting somewhat, the merchandise trade balance is likely to improve slightly this year and next, mitigating the negative contribution to GDP growth from the external balance. Still, the current account deficit is set to widen somewhat, largely accounted for by an expected normalisation of private transfer inflows to more moderate, average levels.

Graph 2. Public finances in Macedonia



The government is expected to continue providing a positive fiscal impulse to domestic demand this year and next, by further increasing social transfers, pensions, and public wages. At the same time, significant budget funds, and financing by state-owned enterprises, are earmarked for further public infrastructure investment. The recent and envisaged increases in entitlement spending are already leaving their mark on budget performance - in the first two months of 2015, the accumulated budget deficit amounted to some 25% of the full-year budget target, or 0.8% of projected GDP.

Graph 3. Republic of Macedonia

	2013		95-10	Annual percentage change					
	bn MKD	Curr. prices		% GDP	2011	2012	2013	2014	2015
GDP	499.6	100.0	2.7	2.3	-0.5	2.7	3.8	3.8	3.9
Private Consumption	359.2	71.9	-	-5.4	1.2	2.1	2.3	2.8	2.9
Public Consumption	88.5	17.7	-	1.2	2.4	2.5	-1.2	2.0	2.2
Gross fixed capital formation	89.4	17.9	-	13.3	6.5	-16.6	13.5	8.5	7.1
of which: equipment	-	-	-	-	-	-	-	-	-
Exports (goods and services)	218.7	43.8	-	16.1	2.0	-2.7	17.0	8.8	9.9
Imports (goods and services)	309.3	61.9	-	8.0	8.2	-10.0	14.5	6.5	7.8
GNI (GDP deflator)	484.9	97.1	-	1.8	0.0	2.6	4.4	3.4	3.7
Contribution to GDP growth:									
Domestic demand			-	-0.8	2.8	-1.9	3.9	3.9	3.8
Inventories			-	1.3	1.2	-0.9	1.4	0.0	0.3
Net exports			-	1.8	-4.5	5.5	-1.5	-0.1	-0.2
Employment			-	1.1	0.8	4.3	1.3	1.9	1.9
Unemployment rate (a)			-	31.4	31.0	29.0	28.1	27.4	26.4
Compensation of employees / head			-	0.0	2.0	1.2	2.2	3.1	3.6
Unit labour costs whole economy			-	-1.2	3.3	2.8	-0.3	1.2	1.7
Real unit labour cost			-	-4.8	2.3	-1.4	-1.7	0.3	0.4
Saving rate of households (b)			-	-	-	-	-	-	-
GDP deflator			3.9	3.7	1.0	4.3	1.5	0.9	1.3
Consumer-price index			3.2	3.9	3.3	2.8	-0.3	1.2	1.7
Terms of trade goods			-	10.8	3.3	-0.8	1.8	-0.1	0.0
Trade balance (goods) (c)			-16.2	-25.2	-26.5	-22.9	-21.7	-21.5	-21.3
Current-account balance (c)			-5.8	-2.5	-2.9	-1.8	-1.3	-1.4	-1.8
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-	-	-	-	-	-	-
General government balance (c)			-	-2.6	-3.8	-3.9	-4.2	-3.8	-3.6
Cyclically-adjusted budget balance (d)			-	-	-	-	-	-	-
Structural budget balance (d)			-	-	-	-	-	-	-
General government gross debt (c)			-	27.7	33.7	34.2	37.8	39.1	40.5

a) as a % of total labour force. b) gross saving divided by gross disposable income. c) as a % of GDP. d) as a % of potential GDP.

CONCLUSIONS

SME development cuts across sectors, involves multiple stakeholders and necessitates concerted actions by the public and private sectors. Therefore, SME development should be mainstreamed into the national development framework. Building up market institutions should be accompanied by capacity building of appropriate institutional structures.

Although competitiveness is a firm level phenomenon, macroeconomic and microeconomic environments influence market signals. To enhance SME competitiveness, therefore, requires the creation of enabling legal, regulatory and administrative environments, access to finance and capable institutional structures, and most importantly human capital and a sustainable environment. Removing supply-side constraint to trade and investment, require firms to build up their competitive advantages. However, competitive advantage is measured in relation to rivals in the markets firms compete in. Integration into regional and global trade and investment networks will require much effort, although it is not an impossible proposition. Public and private sectors in transition and developing countries must work together to improve the functioning of markets at home, while intensifying efforts to integrate into the world economy. Improving the investment climate for SMEs, and strengthening their capacities to respond to trade and investment opportunities, does strengthen the economic performance of SMEs and this in turn has a positive impact on growth and poverty reduction. Each country has to find its own way to strengthen the legal, policy and institutional frameworks in which SMEs operate and which set the quality of the enabling environment.

Regarding the analysis, the key components of an SME strategy which Macedonia should consider includes (World Bank, 2013e):

- the ability of SMEs to implement competitive operating practices and business strategies.
- Increase efforts to develop and strengthen enabling legal, regulatory and administrative environments at local, regional and national levels, where property rights are clearly recognized, contracts are easily enforced, transaction costs in setting up and doing business are financial, judicial, and other governance systems and procedures.
- Facilitate availability of and access to loan and equity finance, particularly medium to long-term opportunities to improve trade and investment capacity of SMEs.

- Strengthen infrastructure services delivery to facilitate market access and reduce the cost of doing business. More investment is needed in key areas such as energy, transportation and communications.
- Reinforce support structures for private sector/SME development, particularly institutional support. SME development strategy should be coordinated and monitored at the central level through a lean, but high level institution and progress should be reviewed jointly by public and private sector. SMEs need business services to improve their competitiveness (*i.e.* information, consulting, training, accounting, legal, advertising, marketing, courier services, technical and technology services, including testing for standards and certification requirements abroad, product upgrading, etc.).
- Enhance policy coherence at regional, national and international level and actively manage aid effectiveness by: 1) joined-up government nationally; 2) country-based and international donor coordination and pooling of technical and financial resources at appropriate levels; and by 3) complementing official development assistance (ODA) made available to transition and developing countries for capacity building in trade and investment with appropriate market access (World Bank, 2013d).

As final remark, taking in advance that the role of the exchange rate as a nominal anchor derives from the characteristics of the domestic economy, as a small and open economy that is highly dependent on the import of primary commodities. This means that Macedonian exchange rate can be used as an instrument for export performances of the SMEs. Macedonian policymakers should create policy with several aims focused on exchange rate policy because this will enhance the SMEs exports:

- ✓ A competitive real exchange rate provides an incentive for exports of the companies
- ✓ The impact of exchange rates on trade should be seen in the context of continued integration of supply chains
- ✓ Exports generally include high import content and impact of foreign currency-exchange appreciation or depreciation on any finished product because it is complex. If the depreciation of the exchange rate makes its exports of finished products "cheaper", it makes imported components "expensive" for domestic producers/domestic SMEs.
- ✓ Maintaining growth and reducing the unemployment in a small and open economy such as Macedonia depends from improved performance of SMES exports.

- ✓ Improving the performance of the SMEs exports can help to preserve macroeconomic stability by closing the gap in the current account to avoid wasting supplies and to stop the growth of external debt.
- ✓ Improving performance requires improving export competitiveness.
- ✓ An outward oriented, market-friendly trade regime, which emphasizes the dismantling of import controls and tariffs (permitting access to inputs at world prices), and streamlined bureaucratic procedures, *i.e.* export and import procedures, modern customs administration and efficient value added tax administration will facilitate exports, including from SMEs.

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