

**Tatjana Boshkov**

**Growing the Global Economy through SMEs International  
Aspirations**



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**To Mirjana and Dimitar**  
**Thank You for giving me life support**

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## **Introduction**

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.

SMEs play an important role in economic growth and development. In this way, globalization and trade liberalization have ushered in new opportunities as well as challenges for SMEs. Only a small part of the SME sector is able to identify and exploit these opportunities and deal with the challenges. The majority of SMEs in developing and transition countries, has been less able or unable to exploit the benefits of globalization and, to add to the situation, are frequently under pressure on the local or domestic markets from cheaper imports and foreign competition. Many transition and developing countries, in particular face a need to promote and strengthen the long term development of the SME sector, which requires access to market opportunities, as well as to new technology and management know-how, often in a situation of considerable resource scarcity.

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 et al., 2003). These 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, 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 this also 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 in the Global Economy**

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 (Metcalf et al., 2003). 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 to 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. Significance of FDI for the SME Sector**

FDI has been seen to be the preserve of large firms, both in developed and developing countries. There is evidence that a growing number of medium sized firms, in particular, are internationalising their operations as a strategic response to increasing competitive pressure. In this context, internationalisation represents a means of reducing costs, as well as of opening up new market opportunities, thereby enabling them to combine greater flexibility with cost reduction (ACCA, 2012a).

This reflects the fact that globalisation is not exclusively a multinational or large firm issue, as a growing number of SMEs are looking to expand their markets internationally. In general, SME internationalisation is greater in smaller, open economies and less in larger economies. One of the best examples is Italy, where 70% of exports are contributed by SMEs (Meghana et al., 2003). In addition, supply chains in sectors such as “high-tech” and component manufacturing are becoming increasingly global in character, contributing to the development of new business opportunities for SMEs as potential suppliers world-wide, and opportunities for local SMEs in developing countries as second or third tier suppliers to main contractors.

One reason why the growing involvement of SMEs in FDI is important is because there is evidence suggesting that FDI by SMEs has some distinctive characteristics in comparison with FDI by larger firms, with potential positive implications for destination economies. For example, a survey of SMEs involved in FDI showed that more than half of their investment involved some form of partnership between the

investing company and a domestic SME (Dunning, 1992). This is because it can be attractive for a foreign investing SME to work with an existing firm, rather than starting from scratch with a greenfield investment, with positive implications for the local SME, in terms of spillover effects. There is also the phenomenon of medium sized companies from mature market economies following larger firms investing abroad, as suppliers.

Although the evidence base is limited, such trends offer potential opportunities, as well as threats, for local SMEs in transition and developing countries. Opportunities may exist for some local SMEs as suppliers to these inward investing medium sized companies, which for a few may represent a stepping stone into wider markets. By encouraging their existing suppliers to become global players, MNEs can help to raise the entry barriers for local SMEs, as potential suppliers, at least in the short term. There is evidence that when SMEs invest abroad independently, they tend to invest in geographically close regions. The reasons for this are limited information fields and greater resource constraints compared with larger firms.

### **3. The Benefits from FDI in the SMEs Sector**

Foreign direct investment is an integral part of an open, international economic system and a major potential catalyst for development. The potential benefits of FDI for host economies include (Lall, 2001):

- increasing the supply of capital;
- technology and knowledge transfer;
- the generation of employment and human capital;
- the effect on enterprise development, through linkages and spillover effects.

An additional source of capital is clearly important in countries where financial constraints act as a major barrier to development. The extent to which potential positive externalities from FDI are achieved in practice is likely to be affected by a variety of factors at the macro- and micro- levels. Human capital spillovers from FDI

in developing countries appear to be mainly indirect, occurring more as a result of government policies seeking to attract FDI through enhanced human capital, than directly from MNEs themselves. However, human capital spillovers can occur where FDI involves the acquisition of a local firm by a foreign company. As capital investment often follows acquisition in such cases, in order to upgrade equipment and machinery, many employees are likely to require training. Moreover, indigenous managers are likely to enhance their knowledge through interaction with foreign managers, with some possibly benefiting from spending working periods abroad.

There are example where FDI has also made a significant contribution to the development of the “high tech” cluster, through linkages between technology partners (Khalid, 1995). In this case, the role of policy was to enhance the development of an initial clustering of research centres by contributing to the attraction of the city as a destination for inward investment. This was achieved through a combination of establishing a consistent policy framework, offering a degree of predictability for foreign investors and an active promotion programme to attract FDI (OECD, 2002).

In this context, it is already known that in Ireland, the Irish firms focused on international supply opportunities which coincided with the establishment of a new agency i.e. Enterprise Ireland (Nilgün, 2002). Enterprise Ireland works with indigenous industry to improve sales, export and profitability through a range of support programmes, with a worldwide network of offices providing a resource through which international supply opportunities can be identified. Alongside the changes in multinational investment, the indigenous Irish sector has matured considerably, with the emergence of some Irish MNEs, which has led to a new role for Enterprise Ireland, in terms of assisting these Irish MNEs to achieve their overseas objectives.

#### **4. Promoting the Link Between SMEs and FDI**

In literature is known that for developing and transition economies, FDI represents a potential means of growing and diversifying the SME base and achieving greater integration within global networks. In this way, if we thinking how to promote the connection between FDI and SME, the answer is creating effective policies which are based on seeking large number of locations in the world with similar characteristics, which clearly affect the bargaining position of individual governments with potential investors and represent key factors that policy makers need to consider for attracting and exploit the potential benefits of FDI. In the absence of other locational advantages, competition between places typically focuses on offering lower costs.

##### **4.1. Policy in Developed Countries**

In developed countries the main policy changes required to increase the economic development benefits of FDI need to be made in host countries. The extent of the market opportunities for SME exporters from transition and developing countries in their markets could be affected (Grilo and Thurik, 2008). Most governments in mature market economies have been involved in export promotion activity for some years, recognising the potential welfare gains for the economy as a whole of increasing foreign earnings.

In transition and developing countries the development of FDI-SME connection would be assisted if the provision of support for the internationalisation of domestic firms in developed countries included co-operation with business support agencies in transition and developing countries. This could help to facilitate partner searching and assisting firms to prepare to co-operate with local suppliers, including raising awareness and understanding of the local business culture; planning for co-operation; and training management and key staff.

Policy makers in developed countries also need to consider how overseas development aid might be better used to leverage FDI through, for example, technical

assistance or infrastructure projects for local SMEs to develop supply linkages with inward investors. Another issue which policy makers in developed countries need to embrace is corporate social responsibility and its implications for supply chain management. This presents a global issue rather than confined to MNE activity in developing countries.

#### **4.2. Policy in Developing and Transition Economies**

To make a strong connection between FDI and SME, policies for encouraging this relationship need to be multidimensional. That is the reason why policy makers in transition and developing countries pay attention to the broader business environment that affects both SME development and their ability to attract FDI. Also they pay attention on making SMEs more attractive as business partners for inward investing enterprises. Their third aim is creation a strategy for encouraging this type of co-operation. In this context, there is need to implement reforms for increasing macroeconomic stability, democracy and a commitment to economic reforms. Another important issue is the importance of high profile publicity efforts, aimed at informing potential investors of improvements in the business environment. The means is that potential investors need to have an up-to-date and accurate picture of the contemporary business environment.

Development of connection between FDI and SME also seek a creation of a business environment that is conducive both to attracting FDI and to facilitating domestic entrepreneurship and SME development (Morriset, 2000). This includes measures like improvements to the general macroeconomic and institutional framework, to increase institutional predictability; creation of a regulatory environment conducive to attracting FDI; upgrading infrastructure, technology and human capital to a level where the potential benefits of a foreign corporate presence for the domestic economy can be realised through positive spillover effects.

Developing effective programmes, agencies and instruments to promote individual transition and developing countries to foreign investors is an important corollary to

policies designed to improve the general business environment. Key priorities in this regard are firstly measures specifically focused on improving the attractiveness of the economy to FDI, such as upgrading infrastructure; removing restrictions on capital flows, and removing any restrictions on imports; and secondly, the establishment of FDI promotion agencies. International good practice suggests these should be at arms-length from government and focused on attracting and facilitating inward investment. There is also a role for specific policies aimed at encouraging and facilitating co-operation between local SMEs and foreign investors by improving the flow of information about suppliers to potential purchasers and about supply opportunities to potential suppliers. The penetration and success of such initiatives is likely to be enhanced if they are introduced in co-operation with appropriate business support agencies and actively disseminated through various channels.

Improving the flow of information about supply opportunities in some way underlines the importance of existing and persuading FDI enterprises to develop transparent programmes which aim to build the capacity of local SMEs. This refers to the need of assisting local SMEs to upgrade in order to meet the demanding quality standards of MNEs, with respect to products and service delivery. Another incentive designed to encourage the development of spillover benefits could include fiscal incentives to encourage training to be provided by MNEs for local staff.

Growth oriented small firms represent a potentially rewarding target group for capacity building initiatives. Capacity building programmes should include supply chain and cluster initiatives, which recognise the potential for developing tiers of suppliers to maximise trickle down effects, including to microenterprises as lower tier suppliers. Policy makers should work with inward investing enterprises, donor organisations and other appropriate intermediaries to develop capacity building programmes for local potential SME suppliers, in order to facilitate the development of backward linkages and other positive spillover effects. Such programmes will need to pay attention to quality management, training and management development programmes. It is important to recognise that a number of governments have adopted special policies and programmes to promote buyer-supplier relationships between MNEs and domestic SMEs, not all of which have been successful (World Bank, 2000). The role of government, is also to facilitate the actions of other actors, namely



FDI enterprises, local SMEs, business support intermediaries and the various providers of technology, education, training and financial services.

Continued attention to the development of an effective business support system is an important condition likely to influence the success of a capacity building strategy. It requires business support agencies, which are customer-oriented and which have a demonstrated capability of penetrating the SME sector. Most governments in mature market economies recognise that the international competitiveness of SMEs depends in part on an effective business support system (Kemal et al., 2002). The general case for state intervention is often based on deficiencies in the markets for information, advice, workforce and management training and finance, as far as small firms are concerned. In a transition and developing context, it is typically necessary for government to intervene in order to contribute to the development of high quality business services, although the nature of the intervention should help to build market capacity in the longer term and not crowd out private sector service providers. An example is the use of accredited private sector consultants to deliver business advice, rather than government advisers. Continued attention also needs to be paid to improving access to finance for SMEs to enable them to undertake any upgrading.

#### **4.3. Strengthening SME Competitiveness in Transition and Developing Countries**

Some reports show that competitiveness is embodied in the characteristics of the firm like (IFAC, 2010):

- 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.

Also, in these reports is analyzed that competitive advantage, which must be measured in relation to rivals in markets, is determined by how efficient and effective

the prevailing markets for products, labor and capital are. They further add that entrepreneurship; the introduction of new productive combinations and innovation is the driving force that continually creates new competitive advantages and opportunities for profit and growth.

Each country will have its own challenges, opportunities and priorities for change when the question is development of SME strategies. Resources available for implementation will vary by country, so that results achieved will also be different. For example, in the 1980s and most of the 1990s, enterprise policy in European countries focused on employment creation, and initiatives supporting new business creation were prominent (White and Chacaltana, 2002). Then, emphasis changed to one of achieving international competitiveness and programs encouraging business growth, support for technology based businesses and creation of an enterprise culture within the society started to gain in importance.

Past and present experiences and practices of developed countries and scholarly assessments of results accomplished are of value and offer a menu of lessons and best practices for transition and developing countries. The responsibility rests with the transition and developing countries to make their choices based on sound assessments of their own context. OECD and other development partners can assist developing countries by building capacities in conducting such assessments, and when they make the choices, by providing capacity building assistance towards implementation (OECD, 2007).

## **5. SME Internationalisation Opportunities**

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 from growth in exports 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 is now expected to rise( from 2.8% in 2014 to) 3.4% in 2015. 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. In addition, export oriented SMEs are also more innovative. So, it is in the public interest to support SMEs to internationalise.

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

1. International SMEs create more jobs
  2. International SMEs are more innovative
  3. Public support goes largely un-noticed
  4. 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;
5. 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.

## **6. Competitive SME Business Practices and Strategies**

It is up to the SMEs to implement competitive business operating practices and business strategies. However, the options available to SMEs are also closely related to the quality of institutions, markets and organizations that constitute the business environment. It is the efficiency and effectiveness of institutions, markets and organizations that encourage or discourage SMEs to take their cues for learning new ways of doing business, compare their own competitive characteristics with those of their rivals, and make their decisions to invest, including the introduction of innovations into their business strategies. If the environment is weak, SMEs' ability to detect market signals that would enable them to invest and grow will also be weakened (OECD, 2000).

Presently, transition and developing countries seem to have a plethora of policies and strategies that relate to the private sector in one way or another: private sector development strategy, SME development strategy, trade and investment policies and strategies, export strategy, and so on. Yet, the responsibility for implementing these various national strategies and programmes are disbursed throughout the public sector institutions, where both capacities and authority to coordinate are weak. Furthermore, there is need to establish dialogue and partnerships between the government, SMEs, the civil society and the academia to appropriately assess and prioritize SME challenges and to implement remedial actions. Governments usually consult with the private sector, though mostly with large and foreign investors, when setting policies since public-private dialogue enhances ease of implementation, political credibility and sustainability strategies. However, there are also capacity deficiencies that must be overcome on the side of SME membership organizations as discussants.

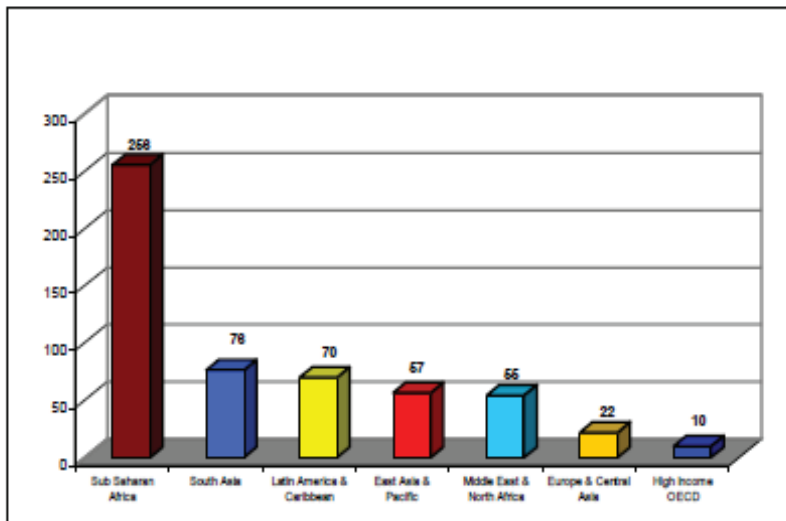
## **7. Access to Finance**

SMEs identify financing, especially medium to long-term finance, as their topmost obstacle to growth and investment. These obstacles come at two levels. In least developed economies, and in some transition and developing economies deficiencies in both the macroeconomic and microeconomic environments pose challenges: high budget deficits and unstable exchange rates and legal, regulatory and administrative environment poses major obstacles to access of SMEs to financing. In some economies, capital may just not be available, property rights regimes may not allow ownership of land, markets for transfer of immovable assets may be very underdeveloped, credit and collateral legislation may not allow certain assets that SMEs commonly have access to, to be used as collateral, absence of registries for mortgages and pledges may increase risks to lenders, contract enforcement and asset liquidation may be hampered due to weaknesses in legislation and in the judiciary. The second level of obstacles may be due to organizational capacity weaknesses: For

example, in least developed economies, business services markets in accounting, auditing, financial management and legal counsel may be so underdeveloped that SMEs may not be able to access or afford such services: essential services they would need when they approach banks and other types of lenders.

In more advanced developing countries, where there is reasonable progress in the fundamental institutions, SMEs may still face challenges in accessing formal finance in the form of bank loans, guarantees, venture capital, leasing and so on. For instance, although SMEs are by far the largest group of customers of commercial banks in any economy, loans extended to SMEs are often limited to very short periods, thereby ruling out financing of any sizable investments. Moreover, due to high-perceived risks in SME loans, access to competitive interest rates may also very limited. Finally, in many developing economies, banks prefer to lend to governments, which offer less risk and higher returns, crowding out most of the private sector from the financial system (World Bank, 2003).

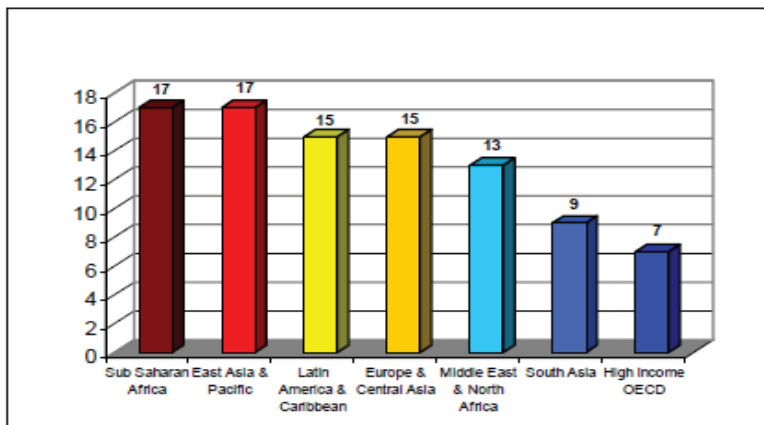
The World Bank's *Doing Business* database provides indicators of the cost of doing business in 133 economies (CIDA, 2003): it identifies specific regulations that enhance or constrain investment, productivity, and growth. Indicators are built on studies of prevailing regulations and cost estimates collected in the field directly from firms (small, independent, limited liability firms employing 5-50 employees), and interviews with organizations charged with administering institutions. The database differs from existing reports on the effects of the business environment on firms, in that; previous studies tend to rely on business perceptions surveys and analyst assessments.



**Figure 1. Cost of starting a domestic SME (% of GNI per capita)**

**Source:**<http://rru.worldbank.org/doingbusiness>

Figure 1 shows that an entrepreneur in a Sub-Saharan Africa economy incurs registration costs amounting to 2.5 times that of GNI per capita, in cash, while the same start up in a high income country would need to spend only 10% of GNI per capita. While the same costs vary from 22% to 76% in transition and developing countries in the other regions of the world, they are still prohibitively high and discourage firms from setting up and formalizing.



**Figure 2. Cost of closing a domestic SME (% of estate)**

**Source:** <http://rru.worldbank.org/doingbusiness>

Figure 2 shows that entrepreneurs in East Asia and Pacific would forego 17% of their estate when exiting, while the same cost would be 7% in high-income countries. It is also interesting to note that there is not much of a difference among developing countries with respect to exit costs. Market exit costs also influence the to-be-entrepreneur's decisions of entry: the higher the cost of exiting, the more difficult will be the decision to invest.

Access to finance can be critical to business growth and success, particularly for start-up enterprises. It can increase the speed at which company grows, fund additional product development, or simply provide enough capital to run the business until the break-even point is reached. Some authors, who take in account this situation in Croatia, analyzed that small businesses are extremely important and certainly most dynamic segment of Croatian economy (Kolakovic, 2010). Its share of the total number of companies in Croatia is 99.4% and they account for 64.8% of the total number of employed persons in Croatia. Small businesses are one of the most important impetuses of the overall economic development which stimulates private ownership and entrepreneurship, employment growth and significantly contributes to increase of production and exports.



In this context, Table 1 shows use of future additional finance/equity of Croatian SMEs. Almost 1/3 of the respondents plan to invest additional finance into technology and equipment, while every fifth enterprise plans to finance purchase of land and buildings, which is favorable usage of additional finance. Slightly less than 17 percent of respondents plan to use additional finance for overcoming their cash flow constraints and maintain working capital. Very common problem of Croatian SMEs is non-payment between enterprises within payment date, which can cause difficulties with cash flow and working capital. Therefore, banks offer quickly available straight short term credit lines (up to 1 year) in order for enterprises to overwhelm those difficulties and ensure continuous usual business operations. Only 14 percent of enterprise plan to hire new employees.

**Table 1. Use of future additional finance/equity Croatian SMEs**

<b>Consequences</b>	<b>No. of enterprises</b>	<b>%</b>
Finance R&D	20	8
Update technology/equipment	68	29
Finance purchase of land and buildings	45	19
Invest in marketing and advertising	16	7
Hire new employees	33	14
Working capital and cash flow constraints	39	17
Investing in shares	2	1
Other	12	5
Total number of enterprises	235	100

**Source:** Bureau of Statistics of the Republic of Croatia

Croatian Employment Service has introduced measures for co-financing the employment of persons up to 25 years old with no work experience, no matter of their educational level. These measures also cover unemployed persons that are in its evidence at least for 12 out of last 16 months, as well as unemployed woman above 45 and men above 50 years old, no matter of their previous work experience and

educational level if they are at least 6 months in the Croatian's Employment Service evidence (Kolakovic, 2010). Special co-financing measures refer to disabled persons, single parents of under aged children as well as parents with 4 or more children. Only 8 percent of respondents plan to use additional finance for financing research and development, while 7 percent of the surveyed enterprises plan to invest in marketing and advertising. Despite recent popularity in Croatia, only 1 percent of enterprises plan to invest additional money in shares.

Financing of early SMEs development phase include seed and start-up financing. Characteristics of seed financing are the necessity for small amounts of money necessary for finalizing business plan, forming managerial team and early product development. Start-up financing is aimed to be the support for the development of SMEs organizational structure. This financing is aimed towards enterprises that are ready to start their business operations. Financing of the start-up phase includes financial support of different funds and state grants in order to ensure full production and investments in different marketing activities.

## **8. The Role of Entrepreneurs**

Creation of effective policies to strengthen the connection between FDI and SME and implementation of reforms with aim to increase the attractiveness depends also from motivation, skills and expertise of the entrepreneurs. In developing and transition country this underlines the need to recognize the importance of inward investment that offer potential business opportunities. These opportunities should expire the suppliers in host country. Entrepreneurs should recognize the need and show willingness to upgrade their knowledge, skills, because if they want to success they must provide high quality product and service. These high quality products and services will bring the competitiveness and satisfy the need of multinational clients (Spanikova et al., 2012). The entrepreneurs also need to recognize any improvements they may be required to undertake as to invest the resources needed to achieve the required upgrading.

In the most of transition or emerging economies the collapse of the state owned enterprise sector and a lack of large privately owned enterprises results in fewer supply opportunities. In this context, inward investment should be seen as a source of potential market opportunities, which policy makers and other stakeholders in national and regional economic development should recognize. An integrated economy development strategy should seek to increase the opportunities that come from the relation between FDI and SME, and use it in the best possible way to strengthen and diversifying the SMEs sector in the country.

## **9. Export-Led Growth: Responses to the Financial Crisis and SME Needs**

Export-led growth refers to a strategy comprising the encouragement of and support for production for exports. The rationale lies in the belief of many economists that trade is the engine of growth, in the sense that it can contribute to a more efficient allocation of resources within countries as well as transmit growth across countries and regions. Exports, and export policies in particular, are regarded as crucial growth stimulators.

Opening up a country's market to the international markets allows a country more efficient production and allocation of resources as the country can concentrate on the production of goods in which it has a comparative advantage based on its factor endowments. Thus, world trade markets allow producers and consumers of the participating countries to benefit from lower prices, higher-quality products, more diverse supply of goods, and higher growth.

Participating in trade, especially export production and promotion, exposes a country to the latest and most advanced production and marketing techniques, and a "learning-by-doing" process that brings about dynamic innovation and technological diffusion into the economy. It also drives a country to higher production and to economies of scale, which lead to increasing returns.

The investment-savings gap and the foreign exchange gap are major obstacles to the growth and development of many developing countries. Since countries need precious foreign exchange for their development needs (capital goods, industrial raw materials, oil, and food), export earnings are a more efficient means to finance these

needs than foreign debt since the latter is vulnerable to adverse exogenous shocks and currency risks that may lead to debt defaults. A similar argument claims that large balance-of- payment deficits, spurred by large import propensities or elasticity's, may be a hindrance to growth for many developing countries. Thus, moderate trade deficits, or trade surpluses, are more desired. This, of course, implies that export growth should be in pace with, or ahead of, import growth.

Export-led strategies allow an expansion of aggregate demand without much inflationary pressure and without the danger of a wage-price spiral, compared with strong domestic demand injections. This partly stems from the real appreciation of the currency that result from large export earnings, which tame inflation and allow real wages to rise.

So, Export-led growth is important for mainly two reasons. The first is that export-led growth can create profit, allowing a country to balance their finances, as well as surpass their debts as long as the facilities and materials for the export exist.

Following this, through ELG is also embodied in the characteristics of the firm like:

- 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.

It is up to the SMEs to implement competitive business operating practices and business strategies.

Presently, transition and developing countries seem to have a plethora of policies and strategies that relate to the private sector in one way or another: private sector development strategy, SME development strategy, trade and investment policies and strategies, export strategy, and so on. Yet, the responsibility for implementing these various national strategies and programs are disbursed throughout the public sector institutions, where both capacities and authority to coordinate are weak. Furthermore, there is need to establish dialogue and partnerships between the government, SMEs,

the civil society and the academia to appropriately assess and prioritize SME challenges and to implement remedial actions. Governments usually consult with the private sector, though mostly with large and foreign investors, when setting policies since public-private dialogue enhances ease of implementation, political credibility and sustainability strategies. However, there are also capacity deficiencies that must be overcome on the side of SME membership organizations as discussants.

### **9.1. Export-Led Growth Hypothesis (ELGH)**

The export-led growth hypothesis (ELGH) postulates that export expansion is one of the main determinants of growth (Greenaway, D. and Sapsford, D., 1994). According to its advocates, exports can perform as an “engine of growth”. Promoting export would enable developing countries to correct imbalances in the external sector and at the same time assist them in ensuring that their domestic economies made a full recovery. As part of an outward strategy, a new set of policies rapidly became a key component for policy makers in developing countries involved in adjustment and stabilization programs.

According to the most authors as well as multilateral institutions would agree that promoting export and achieving export expansion are beneficial for both developed and developing countries for many reasons, including the following:

- they generate a greater capacity utilization;
- they take advantage of economies of scale;
- they bring about technological progress;
- they create employment and increase labor productivity;
- they improve allocation of scarce resources throughout the economy;
- they relax the current account pressures for foreign capital goods by increasing the country’s external earnings and attracting foreign investment; and
- they increase the TFP and consequently the well-being of the country.

## **9.2. Benefits from Export-Led Growth Strategy for an SME**

Opening up a country's market to the international markets allows a country more efficient production and allocation of resources as the country can concentrate on the production of goods in which it has a comparative advantage based on its factor endowments. Thus, world trade markets allow producers and consumers of the participating countries to benefit from lower prices, higher-quality products, more diverse supply of goods, and higher growth. Export-led strategies allow an expansion of aggregate demand without much inflationary pressure and without the danger of a wage-price spiral, compared with strong domestic demand injections. This partly stems from the real appreciation of the currency that result from large export earnings, which tame inflation and allow real wages to rise (Henriques, I. and Sadorsky, P.,1996).

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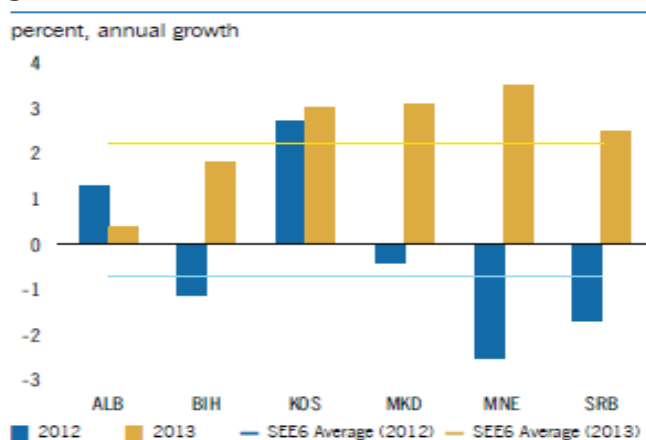
- the current efficiency and effectiveness of the use of resources,
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It is up to the SMEs to implement competitive business operating practices and business strategies. Presently, transition and developing countries seem to have a plethora of policies and strategies that relate to the private sector in one way or another: private sector development strategy, SME development strategy, trade and investment policies and strategies, export strategy, and so on. Yet, the responsibility for implementing these various national strategies and programmes are disbursed throughout the public sector institutions, where both capacities and authority to coordinate are weak. Furthermore, there is need to establish dialogue and partnerships between the government, SMEs, the civil society and the academia to appropriately assess and prioritize SME challenges and to implement remedial actions.

### 9.3. Export-Led Growth in SEE6

The SEE6 countries exited from recession in 2013 with economic growth supported by the recovery in high-income countries, particularly those in the European Union (EU). After a 0.7 percent decline in 2012, the average real GDP of SEE6 grew 2.2 percent in 2013 (Figure 3). All six SEE countries marked positive growth, with growth at or exceeding 3 percent in Kosovo, FYR Macedonia and Montenegro. Only in Albania economic growth slowed in 2013 compared to 2012, though it remained positive. External demand for SEE6 exports was the key driver of this growth recovery, reflecting an improving European and global economy.

**Figure 3: Growth in SEE6, 2012–13**



**Source:** National statistics offices, and World Bank.

On the demand side, exports drove the economic recovery. The gradual recovery in the Euro Area helped goods exports of SEE6 expand by close to 17 percent (Table 2) (World Bank (2012b)). Serbia's exports surged by 25.6 percent in 2013 compared to 2012. Merchandise exports grew across the region, from 2.8 percent in Montenegro

to 13.4 percent in Albania, while services exports performed worse than merchandise exports.

**Table 2: Growth of Goods Exports**

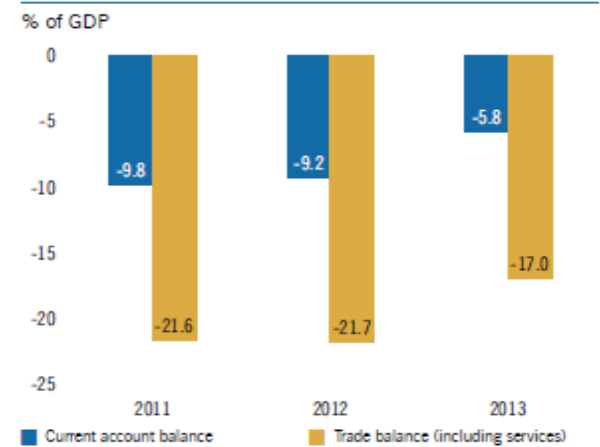
million, Euro			
	2012	2013	change in %
ALB	1,526	1,731	13.4
BIH	2,582	2,807	8.7
KOS	287	305	6.3
MKD	3,107	3,206	3.2
MNE	392	403	2.8
SRB	8,726	10,956	25.6
SEE6	16,620	19,408	16.8

**Source:** World Bank.

An export-led recovery combined with depressed domestic demand resulted in a significant narrowing of current account imbalances in all SEE6 countries. The increases in exports and the declines in imports lowered the trade deficit of SEE countries by 4.7 percent of GDP and the current account deficits by 3.4 percent of GDP in 2013 (Figure 4, Figure 5). Exports to the EU grew strongly, especially in Bosnia and Herzegovina, FYR Macedonia, and Serbia. Montenegro's and Kosovo's share of exports to the SEE region increased. Manufactured goods were the largest share of exports from SEE6 followed by machinery and transport equipment. Jointly they comprised over 60 percent of exports in 2013 in the region. The major increase in 2013 came from export of machinery and transport equipment from Serbia. Exports in FYR Macedonia grew also on the back of machinery and transport equipment as well as chemical materials. Mineral fuels exports were quite significant in Albania and Montenegro, while base metals were around a quarter of exports from Kosovo in 2013.

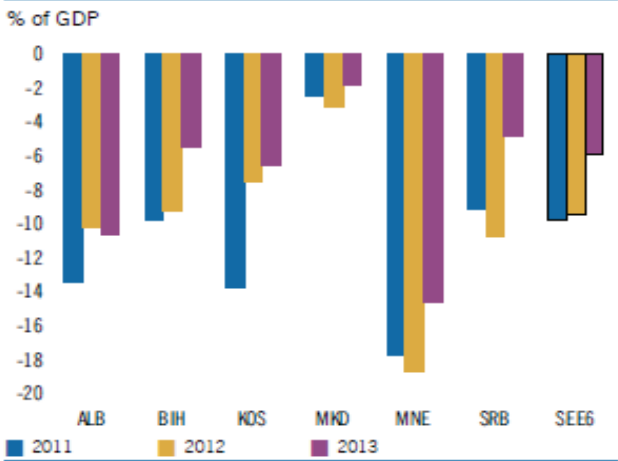


**Figure 4: SEE6 Current Account and Trade & Service Balances**



**Source:** Central banks, IMF WEO, and World Bank staff calculations.

**Figure 5: SEE6 Countries' Current Account Balance**

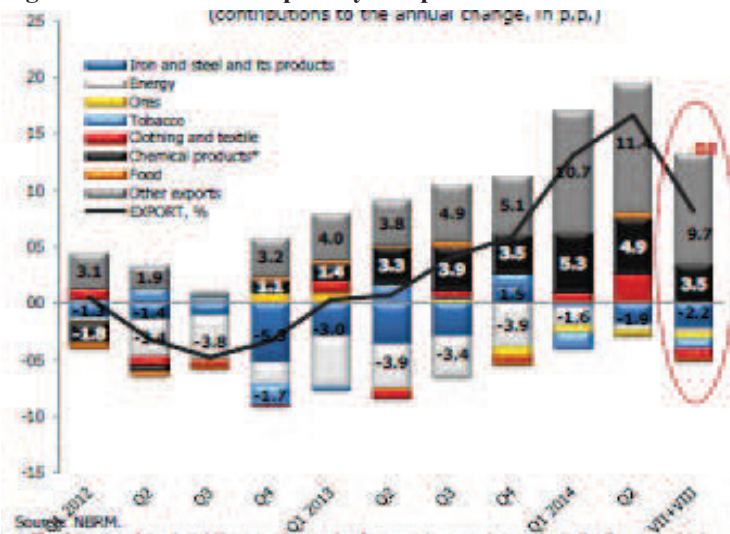


**Source:** SEE6 Central Banks.

The reports by NBRM showed improved performance in the current account in 2013 due to the improved balance of goods and services, amid reduced net inflows in current transfers and higher net outflows in income (NBRM, 2014). The reduction in the trade deficit by 3 percentage points of GDP was mainly caused by a narrowing of the energy deficit, although the non-energy had the same, however significantly milder effect. The individual components of trade registered divergent movements. Exports, driven by the enhanced activity of the new capacities in the economy with foreign ownership, registered an annual growth of 3.2%, while the reduced demand for energy products and the annual decline in energy prices reduced the import component, causing an annual decline of 1.5%. Divergent movements in exports and imports caused stagnation of total foreign trade on annual basis.

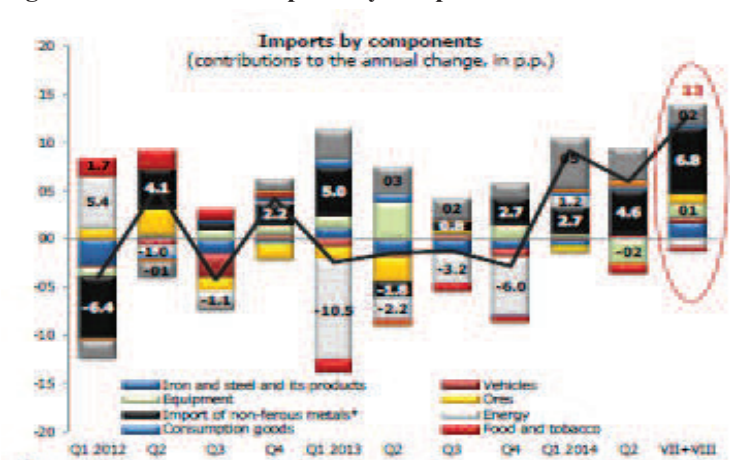
The exports of the companies from the industrial development zones were the most important driver of Macedonian exports in 2013, increasing their resilience, amid still unfavorable global conditions that caused a decrease in the exports of the metal industry. Also, increased exports of new companies were sufficient for offsetting the significant decline in the exported petroleum products, caused by the simultaneous reduction of the exported quantities and lower export prices.

Figure 6. Macedonian export by components



Source:NBRM

Figure 7. Macedonian imports by components

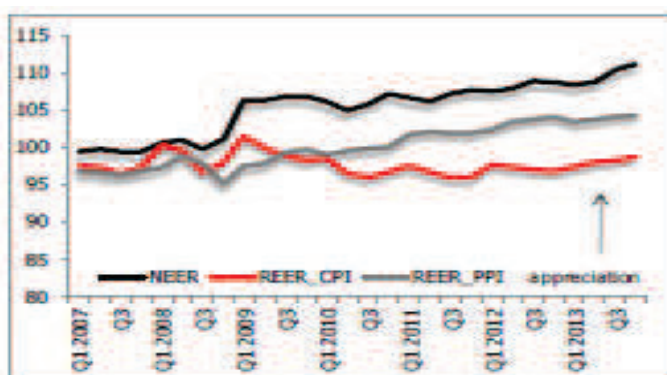


Source:NBRM

In the period from July to August 2014, the foreign trade deficit expanded by 22.4% on an annual basis, conditional on the faster annual growth of import relative to the growth of export activity. Macedonian exports during the second quarter in 2014 recorded an annual growth of 8.2%, and the increased use of new facilities remains a major factor of the positive changes in exports while all other categories acted in the opposite direction, with the largest decline being registered in the export of iron and steel (Figure 6) (NBRM, 2014). On the other side, Macedonian imports in the second quarter of 2014 reached an annual growth rate of 12.7% which was driven by the rising import of raw materials for the new export oriented facilities and metal industry versus the moderate annual decline observed in the energy imports (Figure 7). Larger downward deviations occurred in part of the traditional export products, i.e. exports of iron and steel, ores and tobacco, which is offset with the export activity of the new facilities.

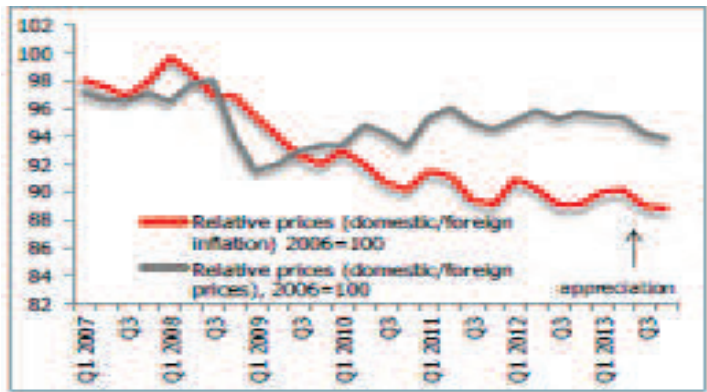
Price competitiveness indicators of the Macedonian economy showed a negligible appreciation of the Denar in 2013. The CPI-deflated real effective exchange rate rose by 0.9%, while the PPI-deflated REER recorded an annual appreciation of 0.4%. The change was entirely caused by the movement of the nominal effective Denar exchange rate, as a result of the appreciation of the domestic currency against the Russian Ruble and Turkish Lira, with favorable slower movements of domestic relative to foreign prices.

**Figure 8. NEER and REER (CPI and PPI, 2006=100)**

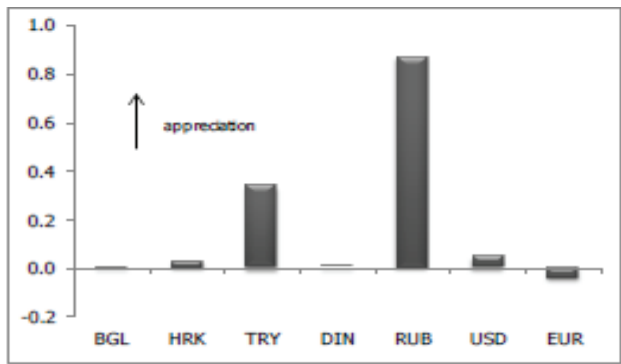


Source: NBRM

Relative prices (2006=100)

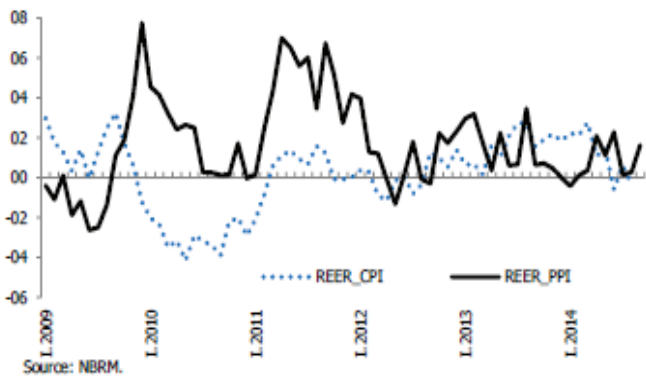


**Figure 9. Contribution to the annual change of NEER of the Denar (in percentage points)**



Source:NBRM

**Figure 10.REER annual changes, in %**

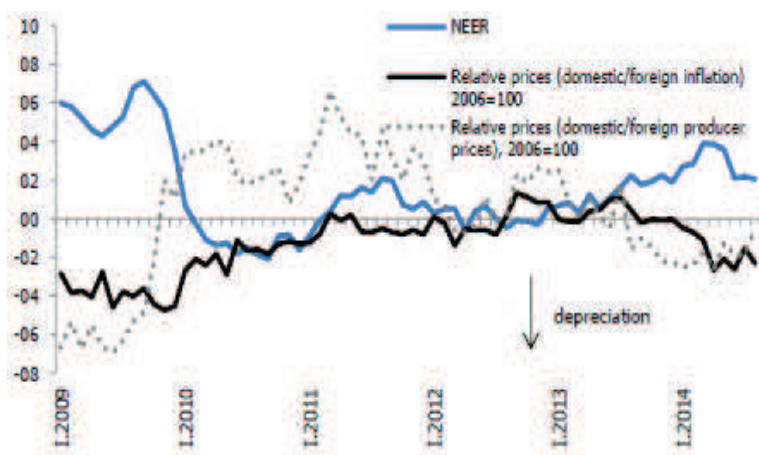


Source: NBRM.

In August 2014, price competitiveness indicators of the domestic economy registered divergent movements on an annual level. When this is compared with the same month of the 2013, the REER deflated by consumer prices

depreciated by 0.3%, while the REER deflated by producer prices appreciated by 1.6% on an annual basis.

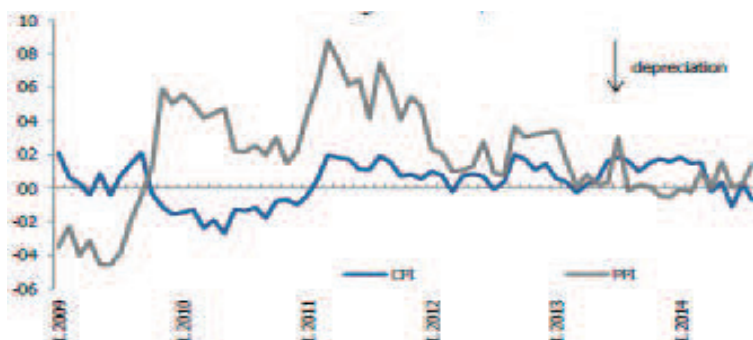
**Figure 11. NEER and relative prices annual growth rates, in %**



**Source:** NBRM.

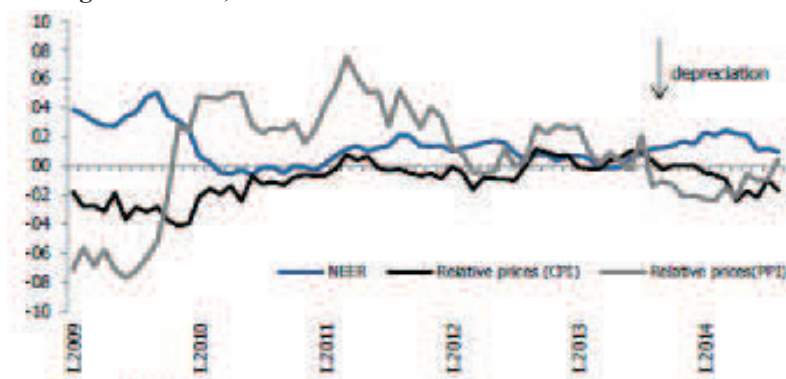
Depreciation of the Ukrainian hryvnia, Russian ruble and Turkish lira against the denar had a influence for the further appreciation of the nominal effective exchange rate by 2% on an annual basis, and this caused upward pressures on both REER indices (NBRM, 2014). The growth of foreign consumer prices and as faster growth in foreign versus domestic prices of industrial products, led to a decline in relative prices by 2.3% and 0.4%.

**Figure 12. REER, excluding primary commodities annual growth rates, in %**



Source: NBRM

**Figure 13. NEER and relative prices, excluding primary commodities annual growth rates, in %**



Source: NBRM.

The movement of the REER , excluding primary commodities, indicates similar movements in the domestic price competitiveness. The REER deflated by producer prices appreciated by 1.5%, while the REER deflated by consumer prices depreciated by 0.7% on an annual basis. Figure 26 show that due to decline in domestic prices, relative CPI registered an annual decline of 1.7%. Also, relative prices of industrial products recorded a growth of 0.5%, driven by



higher domestic prices. NEER appreciation continued in August 2014, annual change driven by the depreciation of the Turkish lira and the Serbian dinar against the denar.

Economic policies can be instrumental for growth in the near- and the medium-term in SEE6. On the fiscal side, sustained reform effort is needed to address structural rigidities in the budgets of SEE6. Priorities include: changes in the composition of public expenditure toward investment and away from wages, public expenditure targeting and prioritization as well as improvements in revenue collection and the broadening of the tax base, among others. On the monetary policy side, with regional inflation at a very low 1.2 percent and big output gaps remaining, some scope for short-term easing of monetary conditions exist, especially in those countries where deficits have begun to decline.

However, caution needs to be exercised in the economies with flexible exchange rates to ensure that these do not come under pressure. In terms of financial sector policies, addressing the high NPLs would be critical to ultimately restoring the growth of credit and supporting entrepreneurship and job creation.

## **10. RER – Policy Instrument for SMES Export Performances**

At the macroeconomic level, sound government policies and the ability to stabilize a competitive real exchange rate are 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 (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.

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. 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.

In the context of pro-active upgrading, this means:

- systematically acquiring production and 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
- actively seeking foreign buyers and marketing agents.

Technical assistance in the areas of quality management, productivity improvement is needed to help SMEs comply with the product standards and regulations applied in export markets.

### **10.1. Supporting SME Export Development and the Role of Exchange Rate**

Globalization has created new opportunities for SMEs. Progressive globalization over the last two decades or so 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. Globalization also brings new challenges. The new international environment provides new opportunities for SME exports from developing countries. It has the potential to offer SMEs in developing countries with access to a global pool of new technologies, skills, capital, markets and hence faster export growth and profits than ever before. At the same time, globalization brings about a multiple array of trade challenges and a sudden increase in competition from imports and the entry of new foreign investors for SMEs in domestic markets. SMEs in developing countries have to adjust to the competitive strategies of MNCs in different countries, to public and privately set standards, to changes in international tastes, prices and competitive conditions.

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.

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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, 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 be to 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. Furthermore, a single export development and promotion agency, which would pursue the national export development strategy, would be needed. Based on good practice in mature market economies, the establishment of such an agency should separate policy making from policy implementation. The agency should (Hudson, 2001):

- Operate in a commercially oriented manner;
- Be result rather than procedure oriented;
- Be staffed by people with relevant, practical business experience;

- Seek to be customer-oriented;
- Include private sector representation on its Management Board; and
- Be funded commensurate with its objectives.

The export development and promotion agency, which could be combined with an FDI function, should develop an export support “offer”, including (IMF, 2013a):

- Provision of information about specific markets and potential customers;
- Help in making contact with potential customers or appropriate public and private intermediaries and business service providers;
- Assistance with market visits.

## **10.2. Exports and Investments Drive Growth in Macedonia for 2014/2015**

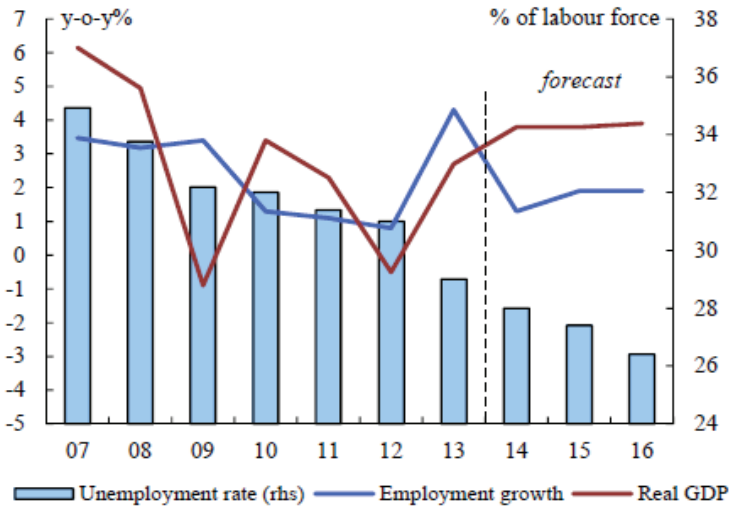
Macedonian output growth accelerated in 2014, driven by exports of foreign investors and public infrastructure investment (NBRM, 2014). Solid gains in household spending further bolstered domestic demand. Given high investment- and trade-related import demand, the foreign balance weighed down on economic activity. Further gains in domestic demand are likely to set GDP growth at an even higher pace in 2015 and 2016, while the negative contribution from net exports is expected to diminish (NBRM, 2014). The 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 (NBRM, 2014). 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(NBRM, 2014). 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.

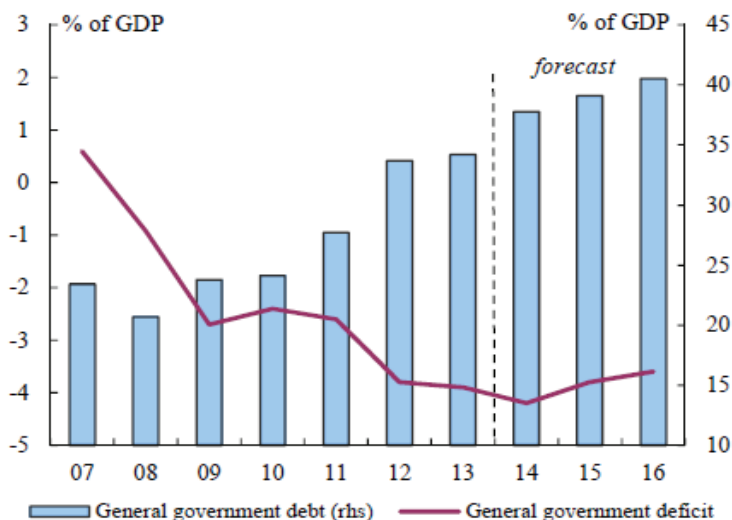
**Figure 14. Macedonian Labor market**



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 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.

**Figure 15.. 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.

**Table 3. Republic of Macedonia**

	2013			95-10	Annual percentage change					
	bn MKD	Curr. prices	% GDP		2011	2012	2013	2014	2015	2016
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	68.5	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.

### 10.3. Export Competitiveness of SMEs in Macedonia

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. Also, 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:

- 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.
- 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 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.

SEE6 growth in 2015 accelerated about 2.6 percent on average. All six SEE economies contributed in increasing growth rates as external demand firms up

and domestic demand begins to recover. Albania, Bosnia and Herzegovina, Kosovo and Serbia had higher rates in 2015 than in 2014. In 2015, SEE6 economies grew slightly slower than the average for the EU11 countries. The external and domestic risks, if they materialize, will affect negatively the prospects for growth in the SEE6 countries and slow the nascent economic (International Monetary Fund, 2016b).

A recent analysis focuses on EU member countries and shows that expanding the growth potential through structural reforms in a stable macroeconomic environment drives strong income convergence (International Monetary Fund, 2016b). Translated to the SEE6, it means that removing structural rigidities in the macroeconomic policy mix, increasing global integration, improving the economy's productive potential and competitiveness, enhancing skills and labor productivity, and strengthening institutions would ultimately contribute positively to income growth and convergence.

Boosting incomes in the medium to long-term with the aim of converging with EU standards will mean not only maintaining the pace of reforms—but also converting reforms benefits into robust and equitable economic growth. Both of these are proving challenging. The reform pace appears to have slowed during the financial crises. Countries will need to take advantage of the economic rebound to re-launch the reform and convergence processes. There is evidence suggesting that improvements in the business climate should be broad rather than targeted toward specific sectors, as growth and employment creating firms tend to be young and dynamic, but not concentrated in any particular sector. Improving trade links in terms of logistics, institutions and regulations will be important to take advantage of the EU market. In addition, governments need to provide reliable and streamlined processes that guarantee EU safety standards are met for exporting firms, particularly for agricultural exporters. Improvements in governance standards—including the rule of law—will be closely linked to the EU integration process. But reforms required by the EU will also help to boost economic growth in SEE6 countries. Such reforms are essential to boost labor demand, reduce unemployment, address the challenges driven by demographic changes and improve prosperity for all in SEE6 in this way enhancing export-led growth and economy growth by SMEs export. Increasing employment is essential to reduce poverty and to bring about shared

prosperity in all SEE6. Since the major source of income for most households is through selling labor, increasing employment opportunities and ensuring that workers have the skills necessary to take advantage of these opportunities are essential to increase the income generation capacity of the entire population.

## **11. Using Effective Risk Management Tool for Upstreaming SMEs**

Most investors will be familiar with the concept of currency exposure, with constantly changing exchange rates affecting the cost of investing in international stocks. These same issues also affect companies that operate internationally. So what effect do currency fluctuations have on company profits, and what are they doing to insulate themselves? In this paper we examine this question. Firms can choose to manage their currency exposure through business practices. Having a truly international company can help with this as, theoretically, losses made when one currency falls will be recovered when another rises. Where contracts are concerned business can also set up clauses that reduce this exposure. In many cases this comes in the form of an agreement to protect the client and the company should exchange movements exceed the agreed-upon level. Some businesses also agree on setting all contracts in their core currency, protecting them from any exposure as they always be paid the same relative amount.

Dealing with the currency exposure is all about managing risk, as fluctuations are by very nature unpredictable. However, while private investors only have their own savings to worry about if they fail to manage this risk appropriately, businesses face angry shareholders and a drop in share value – as well as a drop in profits.

In recent years, investments in international financial securities have grown significantly among individual and institutional investors. Broadening portfolios beyond domestic borders may help investors achieve greater diversification. Although the rapid growth in international investments reflects the benefits of

geographic diversification, currency risk can counteract some of these advantages. Since foreign exchange rates can have a significant impact on returns, investors may be interested in hedging this risk where possible and appropriate. Investments in overseas instruments, such as stocks and bonds, can generate substantial returns and provide a greater degree of portfolio diversification, but they introduce an added risk, that of exchange rates. Since foreign exchange rates can have a significant impact on portfolio returns, investors should consider hedging this risk where appropriate. While hedging instruments such as currency futures, forwards and options have always been available, their relative complexity has hindered widespread adoption by the average investor.

How does the exchange rate regime affect firms' incentives to hedge their exposure to currency risk? This question has been at the center of the debate over optimal exchange rate regimes in emerging markets since the financial crises of the 1990s exposed the perils of unhedged foreign currency debt. Yet there is no clear consensus among economists on whether the type (or degree of flexibility) of the exchange rate regime affects the corporate sector's incentives to take on foreign currency denominated liabilities or to insure against depreciation risk.

Two basic views exist in this respect. On the one hand, several authors have argued that pegged exchange rate regimes biases corporate borrowing towards foreign currency, due to an implicit exchange rate guarantee given by the government (Mishkin (1996) and Goldstein and Turner (2004)). Under fixed or pegged regimes, the central bank keeps currency volatility within a pre-announced range, effectively underwriting currency risk (Dooley (2000)). Thus, firms borrow in dollars to benefit from the lower ex ante dollar interest rates, and expect the government to insure them from any potential loss in the event of a large devaluation. A second variant of this argument suggests that because of limited exchange rate volatility under fixed or tightly managed exchange rate regimes, borrowers appear to consider a steep devaluation a low-probability event, and therefore neglect or underestimate the exchange rate risk associated with borrowing in foreign currency. The fact that fixed/pegged exchange rates have played a role in every recent financial crisis since 1994, and that firms

relied extensively on unhedged foreign currency financing in the years leading up to the crisis, is often used as strong evidence for these views.

On the other hand, Eichengreen and Hausmann (1999) and Eichengreen, Hausmann, and Panizza (2005) dispute this view. The authors suggest that at the root of currency mismatches lies the fundamental inability of emerging markets to borrow abroad in their own currency. Inevitably, this leads to an accumulation of foreign-currency denominated debt which firms are simply unable to hedge, even if they have the foresight or prudence to match the currency structure of their assets and liabilities. In addition, McKinnon and Pill (1999) argue that adopting a floating rate regime will actually exacerbate currency mismatches. Because the domestic interest rate risk premium is a direct function of the stability of the currency, exchange rate volatility associated with floating rates will increase domestic interest rates (and thus the incentives to borrow in foreign currency) and make financial hedging more expensive.

### **11.1. International Markets and Hedging**

The level of hedging risk acceptable outside of America varies depending on the context but is normally far less than can be comfortably tolerated in the American context for a number of reasons.

Undeveloped conventional reserves and contingent derivatives are a dangerous mix. Firstly, reserve risk is different, typically the reserve base is almost always conventional, and therefore the undeveloped components of reserves have far more geological-specific risk associated with them than in a resource play. In addition, reserves are often offshore, meaning additional drilling to make up any production shortfall is logistically far more expensive and time constrained in terms of resources to mobilize rigs. Trying to drill your way out of trouble is never a very convincing strategy, but offshore cost and time considerations make it impossible.

Generally, the use of swaps in upstream project finance for conventional reservoirs against non-producing reserves is inadvisable. In the cases of an underperforming reservoir or even a delayed start up of production, "out of the money" swaps can quickly amplify the loss in the event of default. Puts, or differed variations of them, are generally used avoiding any potential contingent liability (apart from the option premium) unless and until reserves are producing. The only exception to this is perhaps where an asymmetrical collar structure can be used to offset the time uncertainty of first oil or gas in a new field development (floor now but with a high level call strike perhaps a year after predicted first oil or gas to allow room for unexpected delays).

This strategy, while providing some mitigation to start-up delays, still does nothing to mitigate reserve risk itself, which is always higher on undeveloped "volumetrically" calculated reserves, so the banker providing the derivative and the oil company CFO must question if the costs saved in premiums for options is worth the potentially huge risk if the field significantly underperforms on first production at a time when the call is out of the money. It might be argued that such an approach is betting not just the loan, the careers of board members (and their bankers), but indeed the company itself on variables that are beyond the control of management in order to save some upfront costs.

Stafford lays out the three essential step to setting up hedging strategy.

Step 1: *Find a bank that provides the hedging tools you need.*

Step 2: *Figure out what kind of exposure you have. (If a significant percentage of your revenue comes from the euro, you're highly exposed to volatility.)*

Step 3: *Enlist someone—an expert or consultant in this area—that can offer unbiased information.*

Regarding these three steps maybe the third one is the most important part. A misquote of an interbank rate can double hedge costs. Any sort of disagreement in implied volatility can double options premiums. It's essential to have some sort of a third party that has access to interbank pricing, who can help to negotiate terms with the bank. There's another reason to consider hedging, too. It may help in beating out the competitors. When companies are able to take their exposure off the books and protect themselves against it, it can be a big boon to their efforts. It's a huge competitive advantage for companies because

many small businesses are just not that familiar with protecting themselves in this way.

While currency movements can affect a portfolio, sometimes those fluctuations can be beneficial to investors. In such cases, currency hedging would actually forego any profits that could be obtained from favorable movements in the exchange rate. So when does it actually make sense to hedge? It is important for investors to assess several factors when deciding whether or not to hedge currency.

- **Investor Outlook:** If an investor believes that a foreign currency will appreciate relative to the Canadian dollar, then investing in unhedged securities is probably more suitable. In this case, if the outlook proved to be correct, the investor would receive both the returns on the underlying security and the gains on the currency. Alternatively, if an investor believes that foreign currency will depreciate relative to the Canadian dollar, then currency hedging may be a viable solution to mitigate losses.

- **Time Horizon:** In the short run, currencies are more prone to diverging from equilibrium than over the long term. Given the higher currency volatility over shorter or medium horizons, hedging may help to eliminate noise from constant changes. Hedging currency may allow investors to attain their goals if they value stability and are seeking to reduce short-term downside risk.

- **Cost:** Currency forwards that are especially liquid, like the U.S. dollar, are relatively inexpensive to hedge. However, for underlying currencies that are less liquid, such as those for emerging markets, hedging foreign exchange exposure may become more costly and less efficient. These higher costs can potentially diminish returns over time. The costs associated with hedging currency may include bid/ask spreads, carrying costs, and margin. Investors should evaluate whether the cost of a hedge outweighs the currency's potential downside risk.
- **Potential Cash Flow Mismatches:** Hedge positions may produce cash flows independent of the assets being hedged. While the change in value of hedged assets attributable to exchange rates should approximately offset the change in the value of the hedge itself, the hedge position may create interim negative (or positive) cash flows as currency derivatives positions are rolled forward. The



situation becomes somewhat more risky for portfolios holding illiquid hedged assets.

## **11.2. Hedging Impact on Real Businesses: *What Can Firms Do?***

Organizations have to evaluate the risks of doing business on an international level. But it doesn't always work in their favour. For instance, McDonalds's saw sales in Europe increase in 2011, but the yearly profits were actually down as a result of a weakening euro. Another example of this at eBay, with CFO Bob Swan admitting that currency fluctuations will hit the bottom line by around their points in 2012. Ralph Lauren reported that although currency changes have gone in its favour so far in 2012, they survived a turnaround in fortunes in 2013.

As with private investors, business essentially have four options to counteract their currency exposure. The simplest approach is just to monitor the changes, and this can be the best option if companies do not think that they are at a particularly high risk from exchange rate fluctuations.

Another is to lock into an exchange rate for a fixed period of time by setting up a forward contract. If the exposure estimates are correct, this can be a beneficial approach. Some international business will also purchase currency in advance if they know that they will be making big purchases and are concerned about volatility.

Third option is to hedge against this exposure via derivatives. Although this may be the most complicated option, it can be effective in limiting exposure to volatility. It can also give a clearer picture of how a company's overseas operations are really performing.

Finally, firms can choose to manage their currency exposure through business practices. Having a truly international company can help with this as, theoretically, losses made when one currency falls will be recovered when another rises. Where contracts are concerned business can also set up clauses

that reduce this exposure. In many cases this comes in the form of an agreement to protect the client and the company should exchange movements exceed the agreed-upon level. Some businesses also agree on setting all contracts in their core currency, protecting them from any exposure as they always be paid the same relative amount. Dealing with the currency exposure is all about managing risk, as fluctuations are by very nature unpredictable. However, while private investors only have their own savings to worry about if they fail to manage this risk appropriately, businesses face angry shareholders and a drop in share value – as well as a drop in profits.

When it comes to the use of commodity derivatives, what constitutes a sensible risk management program depends on context. The nature of underlying reserves, the size, scale, maturity, and sophistication of the company's operations, the petroleum economics of the underlying asset(s), and the fiscal context of the country of operations. Correctly utilized, hedging tools represent a useful way of underpinning value, maintaining liquidity, and managing credit risk. Incorrectly used they can amplify risk significantly.

Currency movements can add or detract significant value within geographically diverse equity portfolios. Investors which have strong views on exchange rates can choose to accept currency risk or to hedge it out from overall risk. Because of their investor-friendly features, ETFs investing foreign equities are convenient vehicles that may allow investors to accept or hedge the associated with currency fluctuations.

## **Conclusion and Policy Recommendations**

Donors (like OECD) have much to contribute in a way that they can help to expedite the learning processes involved by sharing good practices. Also, they can technically and financially assist transition and developing countries in overcoming barriers, most importantly, they can ensure that improved market access complements improved competitiveness of SMEs. 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.

Another important strategy to promote and strengthen the connection between FDI and SME is facilitation availability and access to loan and equity finance, particularly medium to long-term opportunities to improve trade and investment capacity of SMEs. Access to finance for development purpose may be enhanced by ensuring that contracts are easily enforceable; issues of collateral and security are managed competitively; financial institutions are managed prudently and are trusted by depositors; legal frameworks enable a sufficient number and type of financial instruments to be used; financial institutions other than banks are functioning; SMEs are encouraged to keep good accounting records. Without access to medium and long-term finance within the economy, SMEs would not be able to make the necessary investments in innovations and technologies to improve their trade capacity and act as partners to foreign direct investors.

Creation of effective policies to strengthen the connection between FDI and SME and implementation of reforms with aim to increase the attractiveness depends also from motivation, skills and expertise of the entrepreneurs. In developing and transition country this underlines the need to recognize the importance of inward investment that offers potential business opportunities. These opportunities should expire the suppliers in host country. Entrepreneurs should recognize the need and show willingness to upgrade their knowledge, skills, because if they want to success they must provide high quality product

and service. These high quality products and services will bring the competitiveness and satisfy the need of multinational clients. The entrepreneurs also need to recognize any improvements they may be required to undertake as to invest the resources needed to achieve the required upgrading.

Nevertheless, a substantial amount of work has been done to assess the roles that SMEs play in driving GDP growth and sustaining employment. The evidence suggests that SMEs are vitally important in both high-income and low-income economies, worldwide. SMEs were adversely affected by the global financial crisis of 2008. Some have continued to struggle, with revenues and employment levels remaining subdued in the following years. Others have recovered relatively fast, indicating the resilience of the SME sector. Many have suffered from reduced access to finance and increased costs of credit. Governments around the world have responded in a variety of ways. To assist SMEs in particular, policymakers' attention has focused on supporting working capital, easing access to finance, implementing a better regulation agenda, and encouraging SME investment in new technologies or markets.

Evidence also shows that when SMEs become internationalised, particularly when they start exporting to foreign markets, their contribution to their home economy increases. For this to happen, substantial barriers need to be overcome. SMEs can face difficulties in financing international activity, identifying opportunities and making appropriate contacts in their target markets.

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.

The text above as the analysis also highlights the need for SME size-classes and sectoral differentiation in the design and implementation of new policies and regulations. Also, micro-SMEs and solo entrepreneurs should be treated differently. It is important to take into account when developing SME policies that the majority of SMEs operate in sectors characterised by low export intensity and only a relatively small proportion of SMEs operate in high-tech manufacturing or knowledgeintensive services (Srinivasan and Archana.2011).

In order to ensure sustainable SME growth and performance, the main challenges facing SMEs should be addressed effectively through the development and implementation of new and innovative policy solutions. For instance, even though a great deal of policy focus has been dedicated to improving access to finance for SMEs over the last couple of years, which is still a main barrier for SMEs. Thus, it is necessary to implement a "Secondary Stock Exchange Market for the SMEs", in addition to improving the efficiency of the existing financing schemes(Hudson et al., 2001). This could be achieved through the increase in the number of financial intermediaries at the national level, the reduction of the administrative burden and the increase in the awareness of all existing support schemes among SMEs and financial intermediaries. In addition, SMEs should be guided and supported through the

entire process of accessing finance via dedicated one-stop-shops where appropriate solutions according to their size, sector and purpose (e.g. for R&D, innovation, expansion, modernisation of manufacturing, implementation of energy efficiency solutions, internationalisation, digitisation, etc) are readily available and provided.

With regards to the other main challenges facing SMEs, such as the difficulty in finding customers, doing business, and the high costs of production and labour, this can be solved through the combination of horizontal and vertical policy formulations (Srinivasan and Archana.2011).

In order to further boost the innovation capacity and capability of SMEs, which influences their export potential and competitiveness, user-centric open innovation as well service innovation in combination with technological innovation concepts should be supported by an appropriate policy and regulatory framework (Srinivasan and Archana, 2011). Also strategic support should be provided for project risk analysis, business plan development support and the organisation of brokerage events for SMEs to meet with investors and other potential collaborators for fund-raising and commercialisation of output.

While policies to support the internationalisation of SMEs and their growth in hightech manufacturing or knowledge-intensive services are essential for the future economic well-being of Europe, the many SMEs operating outside these sectors should not be forgotten. The crucial role of SMEs export performances for economic development should be taken into greater consideration through regular and effective consultations with SMEs and SME representatives. Moreover, SME tests and regulatory impact assessments should also be applied not on ad hoc basis but rather systematically as an integral part of policy making.

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