Economic Integration and Export Behaviour of SMEs: The Case of EURO

Workshop on Enhancing the Competitiveness of Small and Medium Sized Enterprises in the OIC Member States

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Outline

- Economic Integration
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  - Importance of Economic Integration for Trade
- Monetary Union as a Form of Economic Integration
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- Proposition on the Export Behaviour of SMEs
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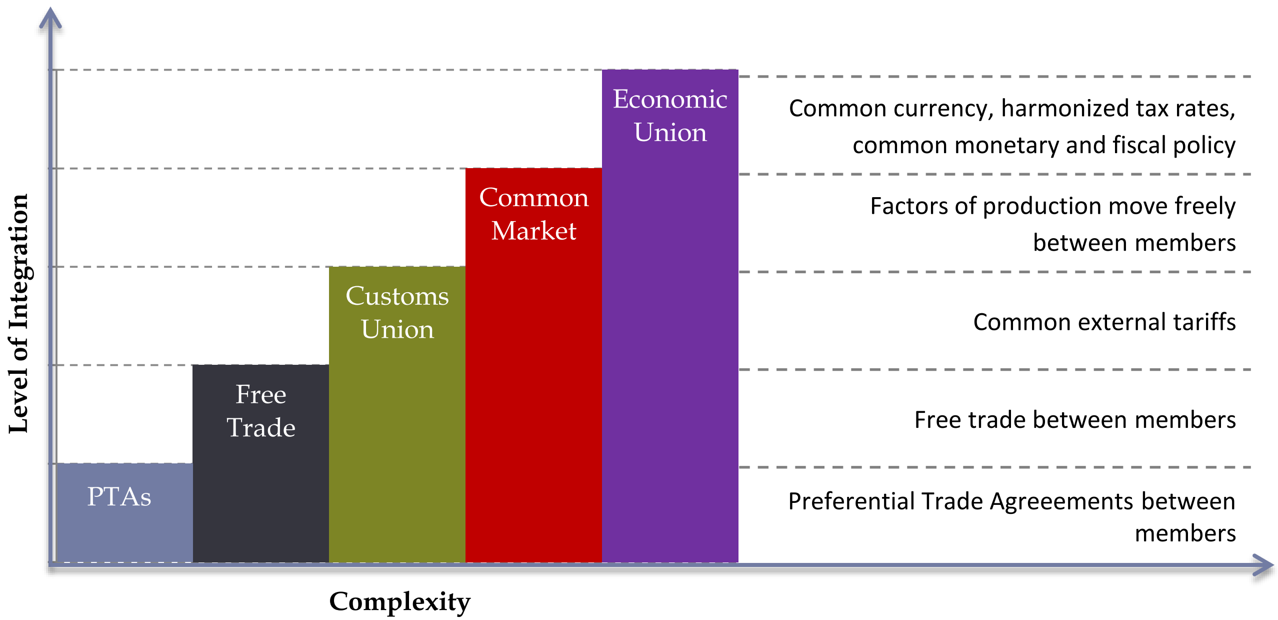
Levels of Economic Integration

- Process whereby the economic barriers between two or more economies are removed to mutual exchange of goods, services, capital and people.
- The economic integration process is often represented as a staged process, going from a preferential trade area to a total economic integration

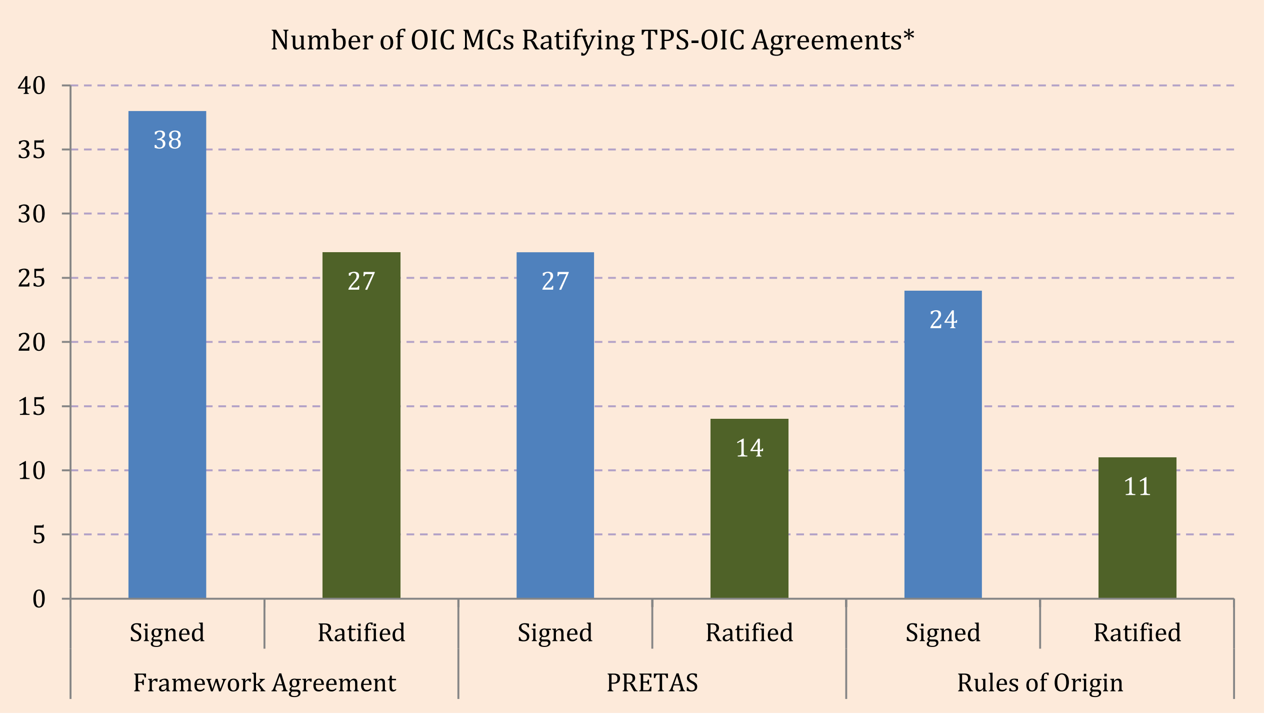


Trends in the World

- Regional and bilateral FTAs tend to increase market-based integration through production networking, outsourcing as part of the global-value-chain system
- Production networking and regional division of labour has resulted in massive vertical intra-industry trade in parts and components within the region
- Multinational and larger enterprises are in relative advantage to benefit from globalization and regionalization compared to SMEs
- SMEs indeed play pivotal role in the functioning of international and regional production networks by utilizing globalizing market forces and regional integration
- There are strong evidence that SMEs are participating in regional and distribution networks particularly in electronics, machinery, ICT, automobile and service industry

Economic Integration among OIC MCs

- All the progress made by the OIC member countries to foster economic integration over the last three decades
  - Only 27 countries ratified the Framework Agreement
  - Only 14 countries ratified the PRETAS
  - Only 11 countries ratified the Rules of Origin



* As of May 2012

Economic Integration and SMEs

- Free Trade Agreements (FTAs), custom unions and other forms of economic integration facilitates the entry into foreign markets.

- In most cases, larger enterprises benefit from economic integration more than smaller enterprises, because there is no direct cost advantage for SMEs compared to big enterprises.

- But, monetary union provides additional cost advantage to SMEs compared to big enterprises.

Monetary Union
as a Form of Economic Integration

- An economic union frequently includes the use of a common currency and a unified monetary policy.
- **Monetary unions** extensively improve the economic environment in which firms operate, mainly through
  - elimination of transaction costs and exchange rate uncertainty,
  - increase in price transparency and
  - possibility to exploit economies of scale at a larger market.
- Additionally, firms save on
  - administrative costs,
  - costs arising from technical regulations being different,
  - costs to obtain information (information costs), and
  - costs from fragile financial conditions.
- Greater nominal exchange rate stability, lower transaction costs, and price transparency reduce costs and thereby enhance competition and increase international competitiveness of enterprises.

Monetary Union and SMEs

Lower costs:

- Managing financial flows at a lower cost is particularly important for small and medium-sized enterprises that are less able to benefit from economies of scale.

Ability to Hedge:

- In managing exchange rate risks, smaller firms are less able to hedge than larger firms because of three main reasons.
  - The use of derivative markets is more costly for smaller transactions.
  - They are also less likely to be diversified in terms of the currencies in which they transact.
  - Lastly, small firms are less likely to have the financial resources to absorb adverse currency movements.

Monetary Union and SMEs

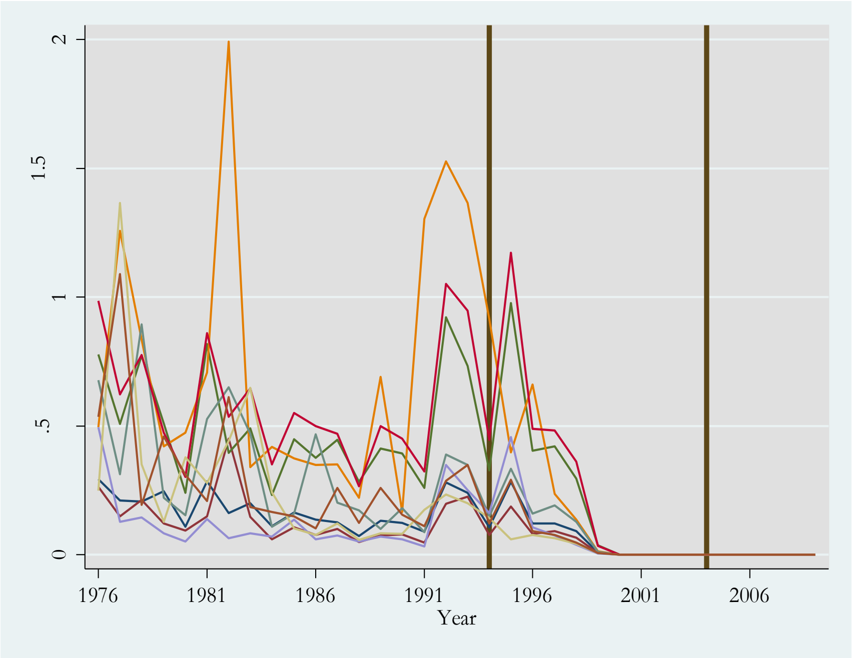
- Exchange rate uncertainty discourages firms from selling in foreign markets due to a lack of price transparency as well.
  - Although the price will be known at the point of transaction when paid for immediately, the actual price in terms of domestic currency will remain unknown. This will apply to many transactions between firms, where payment is often made a month or more after delivery of the goods.

- Therefore, monetary union is especially beneficial for small firms' trade as it improves the operational capability by removing currency risk, increasing transparency, and reducing transaction costs within the union.

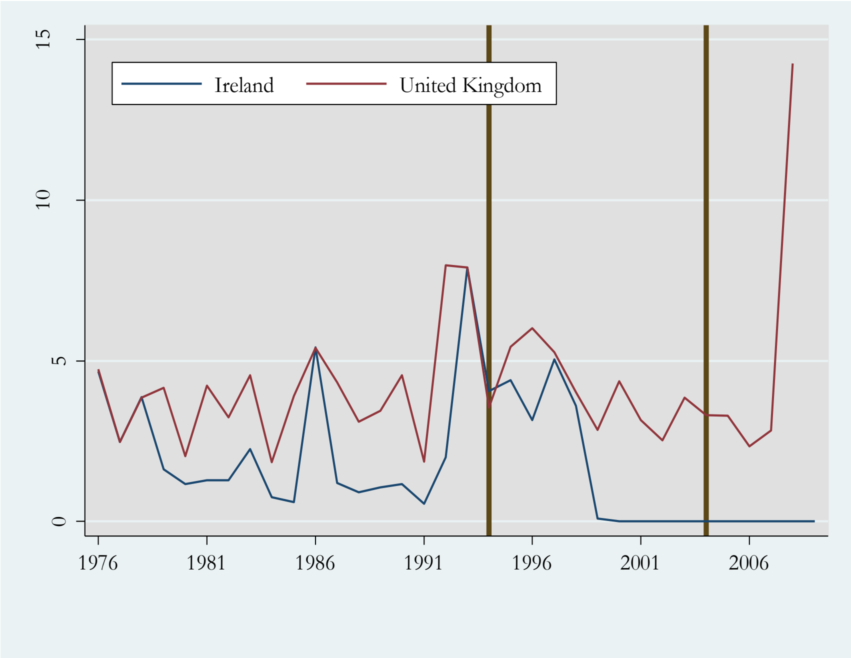
Exchange Rate Volatility in Europe

Exchange rate volatility disappears after monetary union.

a. Volatility in the Former Euro Area



b. Volatility in Ireland and UK



Note: Former Euro Area countries include Austria, Belgium-Luxembourg, Finland, France, Germany, Italy, Netherlands, Portugal, and Spain.

MU and Trade:

Literature on the Impacts of Euro

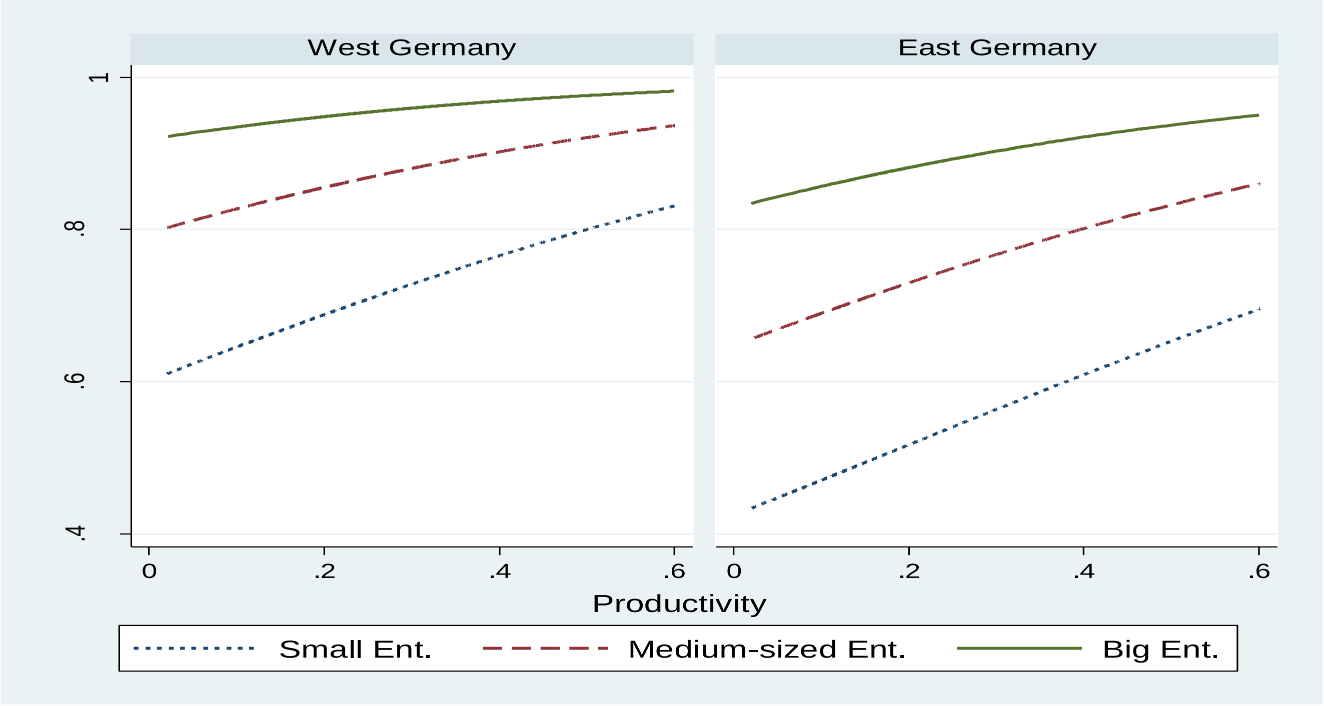
- Economic integration increases trade
- Trade effects of monetary union specific for the Euro area
  - Micco et al. (2003) find 5-10% increase in bilateral trade
  - Bun and Klaassen (2004) suggests a 3% increase in trade
  - Baldwin (2006) argue that a rise in the number of exporting firms in a given country is likely to be the key to explain trade creation.
  - Fontagné and Freudenberg (1999) find that the elimination of exchange rate variability has fostered product differentiation in European trade
- Baldwin and Taglioni (2004) show that exchange rate volatility naturally hinders exporting by small firms, so reduced volatility tends to especially promote exports from small firms.
- Esteve-Pérez *et al.* (2011) find that the introduction of the euro has remarkably weakened the role of firm size in the decision to export to the Eurozone.
- Extensive margin vs. intensive margin

The Proposition on
Likelihood of SMEs to become Exporter

- Average cost of doing business with multiple currencies will be higher for SMEs than big companies and SMEs will initially not be able to enter into export market due to higher average trade costs. As costs due to multiple currency transactions are eliminated, these firms will over-proportionately benefit from cost reductions.
- Reductions in trade costs increase the profits that existing exporters can earn in foreign markets and reduce the export productivity cutoff above which firms export.
- There are two different mechanisms that may bring about an increase in the number of exporting firms.
  - The first one is the direct mechanism: if firms sell or want to sell abroad, their trade-cost-inclusive marginal costs will decrease and they will better compete with incumbent firms in foreign markets.
  - The second one is an indirect mechanism and concerns the firms that do import some intermediary inputs from foreign markets to become more productive. For these firms, marginal costs will fall and they will automatically update to exporter status, provided that they are productive enough.

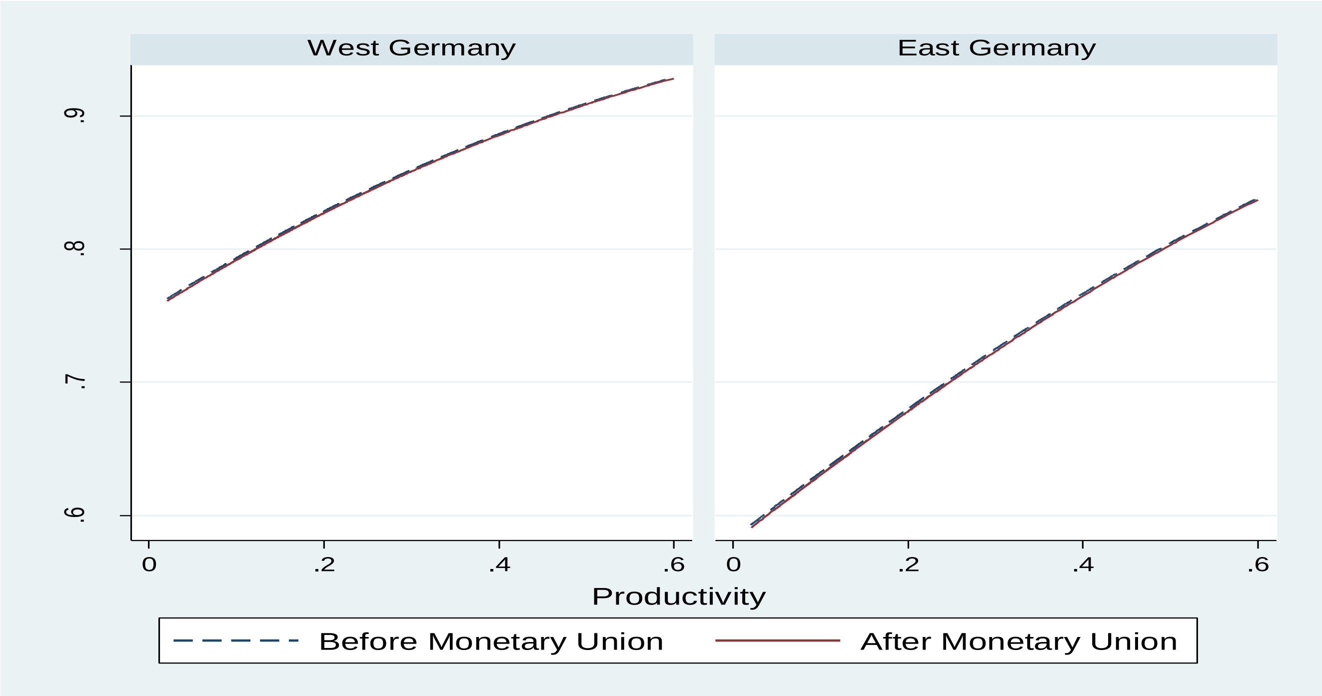
Findings

- Predicted Probability of Exporting vs. Firm Size



Findings

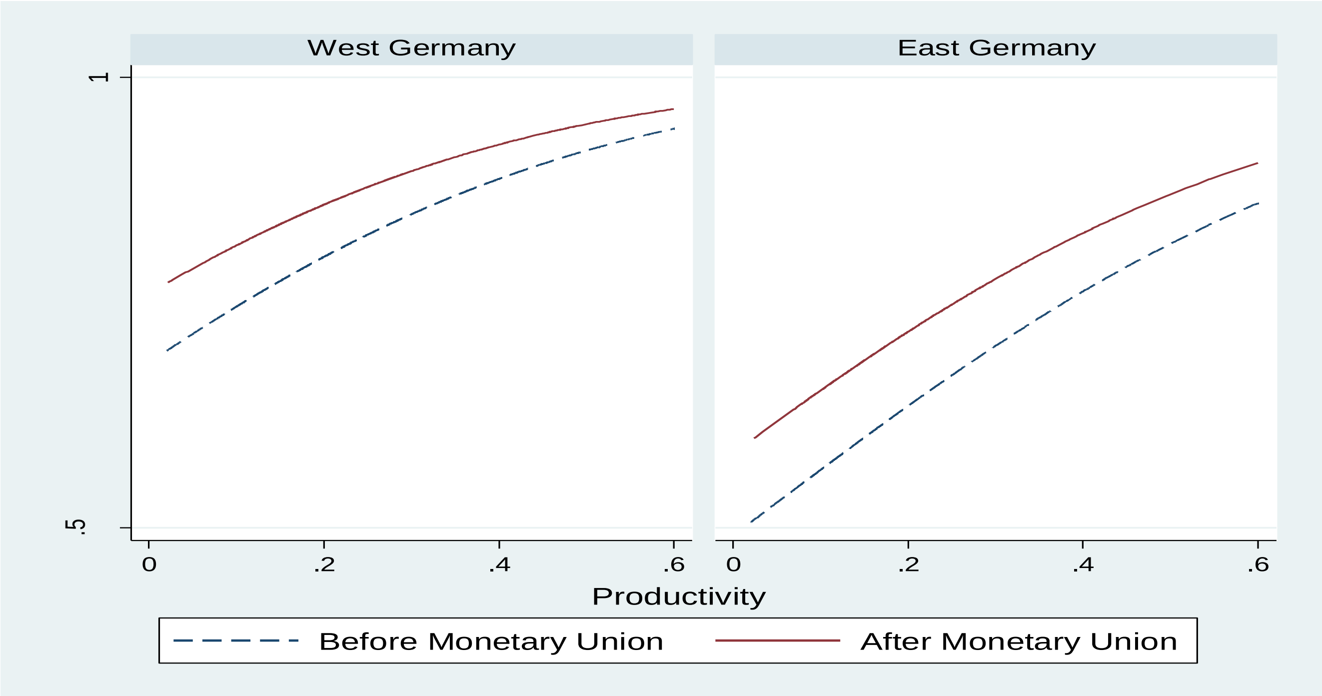
- Predicted Probability of Exporting for SMEs before and after Monetary Union
- Small-sized Enterprises



Findings

- Predicted Probability of Exporting for SMEs before and after Monetary Union

Medium-sized Enterprises



Estimation Results

Table: Export Behavior of SMEs			
	SMEs	Small Enterprises	Medium-sized Ent.
Productivity	**0.435+**	**0.363+**	**0.530+**
	(0.064)	(0.064)	(0.066)
Size	**-0.184+**	**-0.231+**	**0.089+**
	(0.015)	(0.018)	(0.016)
Size x Mon. Union	**0.066****	**-0.001**	**0.062*****
	(0.031)	(0.023)	(0.021)
Skill	**-0.020+**	**-0.025+**	**-0.019*****
	(0.006)	(0.006)	(0.006)
R&D Intensity	**1.784+**	**1.952+**	**1.851+**
	(0.249)	(0.249)	(0.263)
Non-innovator	**-0.158+**	**-0.131+**	**-0.179+**
	(0.015)	(0.015)	(0.015)
East	**-0.123+**	**-0.141+**	**-0.151+**
	(0.014)	(0.014)	(0.014)

Notes: Table presents the marginal effects obtained from standard probit estimation. All estimators include year and industry dummy variables. Small enterprises are the firms with less than 50 employees and medium-sized enterprises are the firms with more than 50 but less than 250 employees. Robust standard errors are in parentheses. Statistical significance are denoted by * p<0.10, ** p<0.05, *** p<0.01, + p<0.001.

Export Behavior of Different Industries

Not all sectors benefit from monetary union!

Table: Export Behavior of Different Industries					
Industries	Coefficient	Industries	Coefficient	Industries	Coefficient
1. Mining	-0.261+	6. Glass, Ceramics	-0.058*	10. Machinery	0.080+
	(0.000)		(0.095)		(0.000)
2. Chemicals	-0.058*	7. Wood, Paper	-0.177+	11. Metals	-0.001
	(0.094)		(0.000)		(0.957)
3. Electrical Equipment	0.080+	8. Plastics	0.090+	12. Furniture	0.138+
	(0.000)		(0.000)		(0.000)
4. Food, Tobacco	-0.206+	9. Medical and Other instruments	0.074***	13. Textiles	0.086+
	(0.000)		(0.001)		(0.000)
5. Transport Equipment	0.000				
	(0.990)				

Notes: Table presents the marginal effects obtained from standard probit estimation for different industries. All estimators include year dummy variables. P values are in parentheses. Statistical significance are denoted by * p<0.10, ** p<0.05, *** p<0.01, + p<0.001.

Consequently …

- Economic integration in the world is increasing rapidly.
- It is clear that monetary union not only decreases the costs of doing business, but also extends the opportunities and improves conditions in which firms do businesses.
- As for SMEs, the management of exchange rate risk is a particularly disadvantageous task for them, as
  - they do not have the critical size which gives them access to the most modern hedging instruments.
  - They also lack qualified staff to discern exchange rate risks accurately.
  - They are sometimes obliged to use the services of intermediaries and that increases their costs even further.
  - Introduction of monetary union effectively removes this disadvantage and makes them more competitive in international markets.

Policy Recommendations

- By reducing costs and burden faced by SMEs, greater economic integration facilitates the entry of SMEs into export markets and increase their competitiveness. Therefore, economic integration among the member countries should be further promoted to enhance the competitiveness of SMEs in international markets.

- Efforts of GCC countries in establishing a monetary union should be supported to enhance the competitiveness of SMEs in the region.

- Policies in West African Economic and Monetary Union should encourage SMEs to trade and increase competitiveness within the union.