Small and medium-sized exporters: Challenges when developing new markets

Thomas Kübler, delegate for regional economic relations

1 Swiss economy benefits from globalisation

Switzerland is one of the world's most globalised economies.[1] This finding is not new. As a small, open economy with few raw materials, Switzerland opened up its economy at a very early stage, enhancing its wealth through extensive integration into a global economy characterised by the division of labour.[2] The Swiss efforts meant an intensive development of export markets. Integration in the world economy also included opening up the domestic market for imports and participating in the global division of labour by fragmenting the added-value chain and locating individual processes in places where the best opportunities lay.

In October 2007, the Swiss National Bank delegates for regional economic relations surveyed 55 small and medium-sized Swiss exporters. Their objective was to try and ascertain why and how well the companies were integrated in the global economy, how they went about this, and the consequences for Switzerland as a business location. The most important findings from the survey were as follows:

- In the past few years, the integration of the Swiss economy within the global economy has proceeded steadily. In general, exports shipped by the companies surveyed are increasing faster than domestic sales; more and more, global sourcing is replacing in-house or local sourcing, and offshoring is moving forward.
- Exporters' target markets are rapidly shifting from western European countries towards eastern Europe and Asia. Most companies are developing new markets on their own initiative. They are doing so step-by-step with the aid of existing networks – or their own networks – without any government support. In general, this development is funded from their own resources.
- The increasing importance of exports is attributable to the dynamic growth in these markets, customer relocations and the expansion of market potential. Due to higher sales volumes, economies of scale can be achieved or the critical threshold attained at which an investment is paid off.

Clearly, Swiss companies are benefiting from the vitality of exports. But does this hold for the Swiss economy as a whole? Or is integration – ultimately – causing parts of companies to be offshored, with the substitution of in-house or domestic sourcing by imports? The findings obtained from the survey were as follows:

- 70% of the companies surveyed have offshored individual corporate functions or business processes. The decisive factor in favour of offshoring in most cases was customer closeness ('follow the customer'). However, increasing cost pressures were also mentioned.
- Mainly, the activities that were offshored were labour-intensive processes in which the Swiss location did not enjoy a comparative advantage. Most of the companies surveyed stated that their home location benefited from this decision since it often triggered additional investments at the parent company in order to increase labour productivity.
- Thus, foreign investment is, in many cases, complementary to equipment investment in the home market. The aim is to retain processes requiring a great deal of expertise at the home location. However, the pressure to relocate even modern technologies and high value-added processes is increasing.

Is it still possible to supply labour-intensive inputs in Switzerland, in view of this increasing concentration on high value-added, expertise-oriented processes? The findings of the survey were as follows:

- The share of imports is rising at about half of the companies surveyed. Moreover, procurement markets are increasingly shifting from regions just across the border to eastern Europe, Asia and, in some cases, Latin America.
- Increased imports are being triggered by lower prices for the imported inputs as well as the fact that, often, the inputs are not (or no longer) manufactured in Switzerland.
- According to the respondents, the imported goods are seldom re-exported without a "large" amount of added value.

1 Globalisation index of the Swiss Institute for Business Cycle Research at the Federal Institute of Technology (KOF) 2008
2 SECO, *Strategische Ausrichtung der Schweizerischen Aussenwirtschaftspolitik,* p. 5, Berne 2005

It may be concluded from the survey that the Swiss economy is benefiting from the increasing integration of companies in the global economy, as well as the growing internationalisation and globalisation of added-value chains. The vast majority of the companies surveyed stated that they had experienced growth in added value, an increase in employment and a rise in productivity at their Swiss location, despite the offshoring of individual processes.[3]

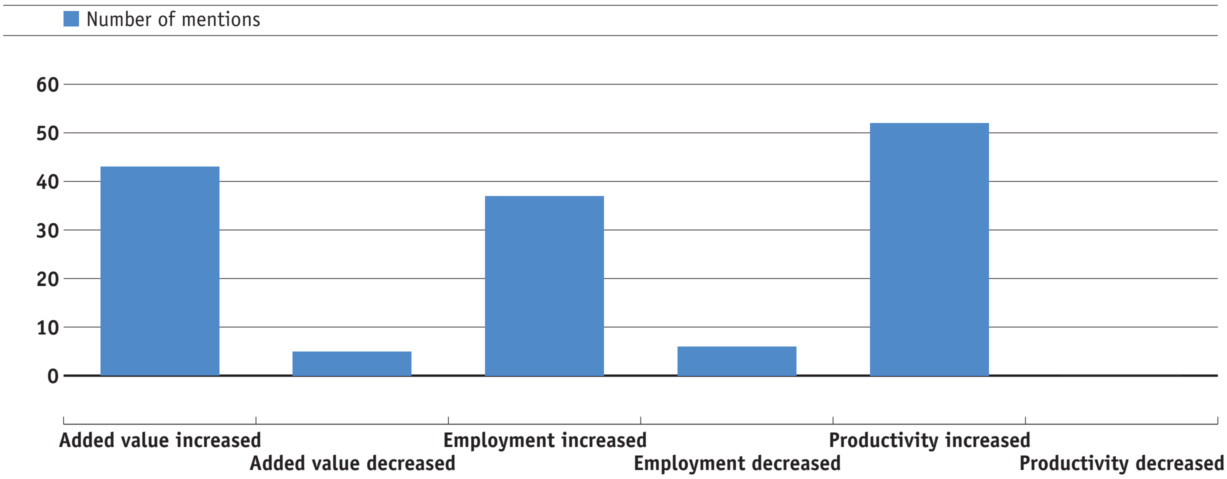
2 Detailed results of the survey

2.1 Strong export performance

The vast majority of survey participants (about 70%) stated that they were growing faster or much faster in the export sector than on the domestic market. Companies with very high export ratios were predominant among those who reported no difference – or very little difference – between domestic and foreign sales figures.

Of the experts surveyed, 18 (about 32%) mentioned the fact that the structure of (or changes to the) institutional framework had promoted market entry. The Bilateral Treaties were mentioned repeatedly, and the freedom of movement of labour, in particular, was singled out. Above all, mention should be made of the improvements and simplifications in access to the European labour market, and the easier recruitment conditions in Switzerland that have resulted. The simplified cross-border employee transfers within corporate groups are also stressed, notably the increased flexibility in the internationalisation of corporate structures that can be achieved in this manner. In addition, respondents were positive about both the expansion of the EU into eastern Europe and the simplified access to new sales and procurement markets that has resulted as well as about the improvements brought about within the context of the WTO.

Graph 1
Net effects of integration



Source: SNB survey, October 2007

3 This corroborates a number of studies on this topic. Cf. Girma / Greenaway / Kneller, *Does exporting lead to better performance?*, University of Nottingham, 2002, or Robert Jäckle, 'Going multinational: What are the effects on home market performance?,' Deutsche Bundesbank, *Discussion Paper Series 1: Economic Studies* no. 03/ 2006; Sascha O. Becker, Marc-Andres Mündler, 'The effect of FDI on job separation,' Deutsche Bundesbank, *Discussion Paper Series 1: Economic Studies* no. 01/ 2007, or Spyros Arvanitis and Heinz Holenstein, 'Determinants of Swiss Firms R&D Activities at Foreign Locations,' *KOF Working Papers* no. 127, 2006.

Survey method and data sample

Survey method

The company survey was conducted in the form of personal interviews using a questionnaire. Companies were chosen selectively with the aim of achieving a data sample that would provide in-depth information about export activities, offshoring and global sourcing. Consequently, the survey is not representative but rather a survey of experts.

Structure of the data sample

In terms of its arithmetic mean (sales: CHF 340 million; staff: 990), the sample is skewed towards companies that are of above-average size. However, if we take the median value, we obtain figures (sales: CHF 120 million; staff: 354) that are typical for a Swiss small to medium-sized company. At about 70%, the proportion of exports exceeds the overall average for the economy (about 50%) by a considerable margin. However, if we bear in mind that the figure for the overall economy also includes public administration and other services provided solely for the domestic economy, we can assume that the sample adequately covers the Swiss export industry.

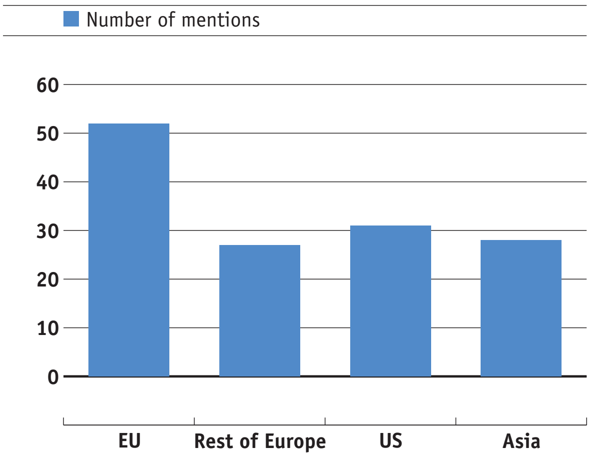
The vast majority of companies surveyed pursue a global export strategy rather than exporting to a single economic region. The EU remains the most important sales market. Western Europe, the US and Japan, say the majority of respondents, have 'always' been targeted, but eastern Europe and the rest of Asia did not come onto their radar screens until the end of the 1990s or the beginning of the 2000s. However, the significance of these regions is now growing rapidly.

2.2 Market access, distribution structures, motives and risk management

When small and medium-sized companies make their first ventures into new export markets, they often encounter challenges they had not confronted before. Even the task of obtaining information or monitoring the market poses difficulties for companies which – because of their size – do not have the requisite specialists. Additional challenges can be summed up as follows: market practices, purchasing power, preferences, the competitive environment, the operating environment provided by the state, financing arrangements, etc. A range of questions also arise when entering new markets: What form should the market entry take? How can distribution structures be established? How can market entry be financed? Finally, the question of the exchange rate risk comes up again – or to a greater extent than previously.

Market entry. The survey reveals that market entry is primarily self-directed. If need be, companies are supported by their own business partners or networks (existing customer or supplier relationships). For larger companies, or in the case of group companies, other group units serve as stepping stones for the entry into new markets. We see that, while business partners or networks hold a dominant position with over 70% of mentions, little mention is made of Swiss government organisations such as OSEC or Swiss embassies (15%), or support by state-backed institutions in the target region (10%).

Graph 2
Geographic distribution



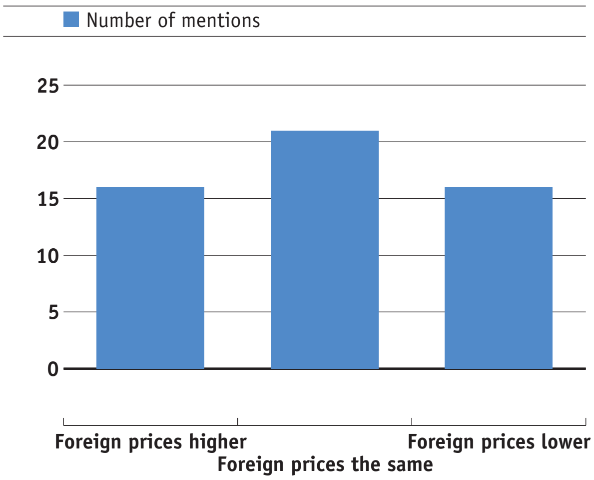
Source: SNB survey, October 2007

Distribution structures. Over time, and also with respect to the level of market penetration, changes in distribution structures may be observed. Typically, agents (30%) or company representatives (20%) are used in the initial phase. Not until the company is established in the market are distribution units established. However, these rapidly become very important (35%). A fairly major proportion of export products is accounted for by plants and systems, while 'the simple sale of products across the border' is less important and is subject to significant offshoring pressure. Consequently, the importance of service and engineering positions abroad is increasing. Internet sales are of secondary importance only. Although e-business would render on-site physical presence unnecessary – at least as far as sales (and possibly also distribution) are concerned – it is almost never used systematically.

Motives. The main motives for commencing or stepping up export activity are as follows:

- 34% of the companies surveyed state that they wish to expand their sales and market area in order to increase output and achieve economies of scale. They are clearly aiming for lower unit costs.
- Slightly more than 20% of respondents earn higher margins abroad. They specialise in niche products and most of them manufacture machinery or systems without strong competition on the market, or where the competition's product is not readily comparable to theirs. Here, the pricing power is with the producer.
- About 45% of respondents cited other motives, these being mostly 'market', 'market dynamics' and 'follow the customer'. The latter is a major driver, particularly for subcontractors. Another motive mentioned is that the Swiss market is close to saturation, while demand in the new growth markets of eastern Europe and Asia is lively.
- High-tech companies refer to the fact that significant changes in materials or production technology demand major investment in equipment if the company is to hold its position at the forefront of technological progress. Yet the requisite high level of capital commitment cannot be refinanced in the limited home market. In this respect, absolute market size (rather than market dynamics, or arguments relating to saturation or offshoring) is the decisive factor.
- Finally, export markets are also chosen quite consciously in order to diversify political risks as well as risks relating to business cycles.

Graph 3
Export mkt prices compared to domestic mkt prices



Source: SNB survey, October 2007

Comparison of prices in domestic and export markets. The question regarding relative prices in domestic and export markets produced interesting results. 16 respondents (30%) stated that prices were higher abroad, while 16 said the opposite. 21 respondents (40%) thought there was no difference in prices. Companies with a particularly strong and valuable brand and companies relying on the 'swissness' label due to the nature of their products often judged export prices to be higher. Companies that claimed they could achieve higher margins and prices abroad said that the value-added in export products was higher than it was in products sold on the domestic market. It was only because of this that the effort involved in selling to foreign markets was worthwhile, they said. Respondents operating in an environment in which prices in domestic and export markets were comparable put forward exactly the opposite argument. Most of them sell products, rather than systems. Moreover, their products and those of their competitors are largely standardised and can be easily interchanged. Consequently, there is little scope for price differentiation from one national market to another, and prices are generally set as a reaction to competitors' prices.[4]

4 Cf. Andreas M. Fischer, Matthias Lutz, Manuel Wälti, 'Who prices locally? Survey of evidence of Swiss exporters,' Centre for Economic Policy Research, Discussion Paper Series no. 6442, 2007.

Financing and exchange rates – exporters' risk management

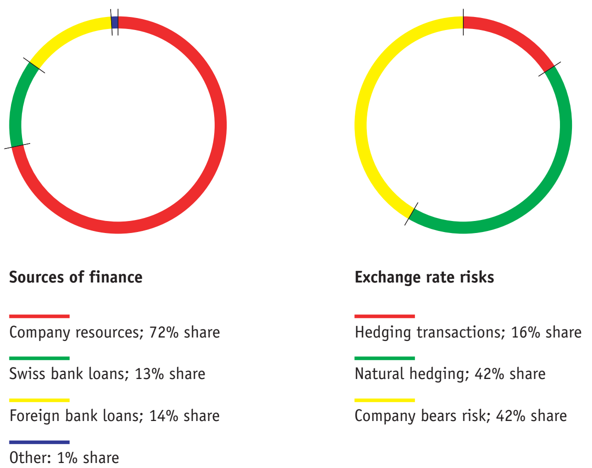
The majority of the companies surveyed finance their exports (establishing structures; day-to-day operations) from their own resources. This is due to the fundamental endeavour on the part of many companies to maintain a high equity ratio in order to secure their financial independence. An additional factor with regard to commitments abroad, they stress, is that domestic banks are very cautious as their organisations abroad are not extensive enough to provide adequate local customer service.

Financing market entry and development from Switzerland is also rated as difficult, since loan departments are not particularly well informed about the markets in question, and recourse to the securities abroad may not always be guaranteed – or can be difficult to enforce. Generally speaking, Swiss bank loans are only used when they can be backed by collateral in Switzerland. However, true growth funding is difficult to implement in this way. For their part, companies tend to give preference to local banks in the new markets, particularly where the country in question carries large political risks. From the company point of view, this reduces the exit costs and improves the negotiating position in the event of state intervention.

Cooperative ventures between Swiss exporters and local operators in the target markets are cited as an interesting strategy. Such ventures appear to be particularly promising when the exporter's technological expertise is combined with the local partner's accurate knowledge of the market. The operational advantages in terms of market entry and market development lie in overcoming the information deficits mentioned. In addition, this kind of cooperative venture seems to provide a foundation upon which combined financing arrangements can be organised. Thanks to the local business partner, the initial investment – usually in infrastructure – can be financed, while the Swiss partner will often provide the operating credit through his commercial bank.

The responses on the management of currency risks are closely related to the responses on offshoring, which are presented in the section below. Only 16% of companies surveyed said that they conduct hedging transactions using modern financial instruments. The vast majority stated that they bear the risk themselves. In the ideal case, this means either that the companies budget carefully, or that they absorb and compensate exchange rate losses and gains over time. Part of the risk is allayed by purchasing more inputs in the currency area in which revenues from exports will be earned, or by consciously locating cost blocks there (natural hedging). With respect to individual currencies, it emerges that the euro risk is initially borne by the companies themselves or reduced by means of natural hedging. The US dollar causes the companies more difficulties. Here the risk is considered to be greater. Nevertheless, hedging is only an option for larger companies.

Graph 4
Financing and exchange rates



Source: SNB survey, October 2007

2.3 Offshoring and imports – offsetting the positive export effects?

40 of the 55 companies surveyed stated that they had transferred corporate functions abroad, in particular, production units and distribution. Other units mentioned were processes that followed the customer or the market (such as maintenance and service, repair units, packaging and manufacture) or production-related processes (such as sourcing or pre-production processes). Typically, these were labour-intensive, value-added processes in which it was clear that the Swiss business location did not have a comparative advantage. The value-creation component was relatively unchanged despite the transfer of these processes abroad. In our sample, it stood at about 60–70%, considerably above the average for the economy overall, which – according to SECO – is below 40% for manufacturing as a whole.[5]

Closeness to the market was the dominant motive in the decision to transfer individual stages in the value-creation chain. This motive is becoming increasingly important, as can be seen from a number of results obtained in the survey. As development of the export market proceeds, the question of where to locate the different processes becomes ever more pressing for companies. The principle of closeness to the customer still appears to be the most important argument. Cost considerations come second. Although most companies attempt to position themselves in niches where price elasticity is low, the pressure on prices and costs is high in the global market.

Despite the international treaties, trade barriers still exist in places. To some extent they can be avoided by producing locally. Similar problems are evident in the case of subcontractors. For instance, some contractors stated that their customers had put pressure on them to transfer part of their production to low-wage countries so that they could reduce costs and increase the local content of the final product.

Increase in imports, but not a 'bazaar economy'

Half of the companies surveyed stated that the importance of imports was increasing for their businesses. The majority of imports were commodities and semi-manufactures; only 23% were finished products. More than 40% of imports were used as inputs for companies' own products, 34% went into final consumption and 25% were re-exported – either directly or after finishing.

Finally, companies were asked whether there had been any changes in the share of imports. 27 respondents said that the share of imports was increasing. The reasons given were the more favourable import prices as compared to local production (58%) and the better quality of imported goods (9%). 33% of respondents said that the products were not (or no longer) available in

Graph 5
Motives for offshoring

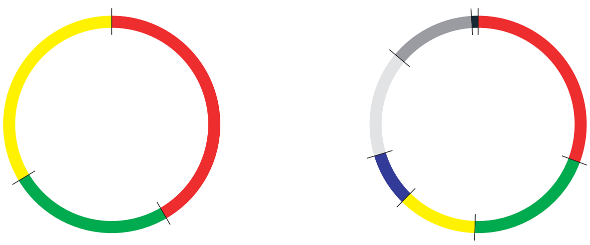
Source: SNB survey, October 2007

5 SECO, 'Outsourcing, Produktionsstruktur und Wertschöpfungsquote,' in 'Die Konjunkturtendenzen Sommer 2007', p. 41 et seq.

Switzerland. A number of responses also revealed that companies now order their commodities direct from their own sourcing companies or via group companies abroad, and no longer source them through regional or national wholesalers. While no in-depth exploration of the discussion on the 'bazaar economy'[6] that is being conducted in Germany will be offered here, the survey results certainly provide no indications that Switzerland can be said to be a "trans-shipment conveyer belt where goods are merely given a polish and shine". Imports are used as inputs or for consumption, or exported following a finishing process.

Looking at the procurement markets, the multiple mentions show that, on average, the companies surveyed source their imports from two countries or economic regions. In other words, purchasing is somewhat less diversified than sales. Measured in terms of the volume sourced from the individual regions, the economies bordering Switzerland and the other 'old' EU countries predominate. Here, too, we note a very strong tendency to transfer imports to the 'new' EU countries and Asia.

Graph 6
Imports, by type, use and origin



Type of imports and their use

Input; share 41%

Re-export; share 25%

Consumption; 34%

Origin of imports

Surrounding area; 31% share

Rest of old EU; 20% share

New EU countries; 12% share

US; 8% share

Source: SNB survey, October 2007

6 H.-W. Sinn, Die Basar-Ökonomie – Deutschland: Exportweltmeister oder Schlusslicht?, Econ Business, 2005

3 Conclusion

This survey of experts from the executive management of 55 Swiss export companies has revealed that integration in the global economy is well advanced and is moving forward at a rapid pace. The integration encompasses the development of both sales and procurement markets, and also involves the fragmentation of the value-creation chain and the decentralised location of individual parts of processes.

Companies are exposed to competition and focus on niche markets and activities with a high level of value creation. Their growth in export markets is faster than that in the domestic market, and they source lower-cost primary products abroad.

Switzerland benefits as a business location from the fact that high value-creation activities (as opposed to labour-intensive activities) are carried out here, that investments are made in infrastructure at the home location as a complementary activity to investments made abroad, and that subcontractors also become highly specialised companies.

As a result of all these factors, the export companies demonstrate that, overall, they have increased value-creation, staff numbers and labour productivity in Switzerland – despite their foreign investment. They thereby confirm investigations showing that companies which are successful abroad create an above-average number of jobs in the domestic market. Extensive integration in the global economy strengthens the competitiveness and growth potential of the Swiss economy.