Encourage and Support Lebanese SMEs to benefit from growth markets

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« Overview of the global value chain ; potential of participation of Lebanon in the value chain»

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1. INTRODUCTION

In general, a value chain refers to the full range of value-adding activities to bring a product or service through different stages of production. This includes design and development, input of raw materials and other factors, selection and assembly, physical transformation and processing, acquisition of required services such as transport and finance, and ultimately response to consumer demand[1].

The term global value chain (GVC) is utilized when part or parts of the value chain operate in different locations or economies. In other words when the various actors of a value chain operate and collaborate closely for the same objective while being in different locations and countries. The GVC can be constituted of vertical links (layers of different suppliers) as well as horizontal links (interaction between suppliers of the same layer).

As a matter of fact global chains did not start to be important except recently; 25 to 30 years ago GVCs were limited to labour intensive sectors such as textile, clothing, electronics and sometimes agriculture but since then they have expanded to almost all industrial and service sectors based on the concept of comparative advantage; meaning that each part or service is produced or delivered in the location having the most favourable conditions, usually the lower cost.

Having said this, the quick development of GVC would not have been possible without the technological advancement that allowed the potential fragmentation of production entities into smaller ones, acting in different locations; the substantial reduction in information costs leading to a more cost effective relationship between buyers and suppliers, and the overall decline in trade costs both in home and host countries.[2] A recent study by the United Nations ESCAP suggests that "improving port efficiency (liner shipping connectivity) and access to information and communication technology facilities are essential to reducing trade costs.

The optimization level of the fragmentation of production units however, depends on a trade-off between lower production costs and higher transactions/co-ordination costs.[3]

A GVC is usually composed of small SME and managed by a lead firm; large GVCs are controlled by multinational companies (MNC) or Transnational companies (TNC); nevertheless this does not imply that smaller companies cannot lead a GVC.

2. HOW ARE GVC GOVERNED?

MNCs govern GVCs under different structures. The governance structure reflects the difficulties and challenges to enable the chains to function. Working with firms downstream and upstream incurs transaction costs – the costs involved in coordinating activities along the chain[4]. Transactions take place at each stage of the GVC among lower-tier suppliers and among higher-tier suppliers.

Gereffi, Humphrey and Sturgeon (2003) mapped five governance structures:[5]

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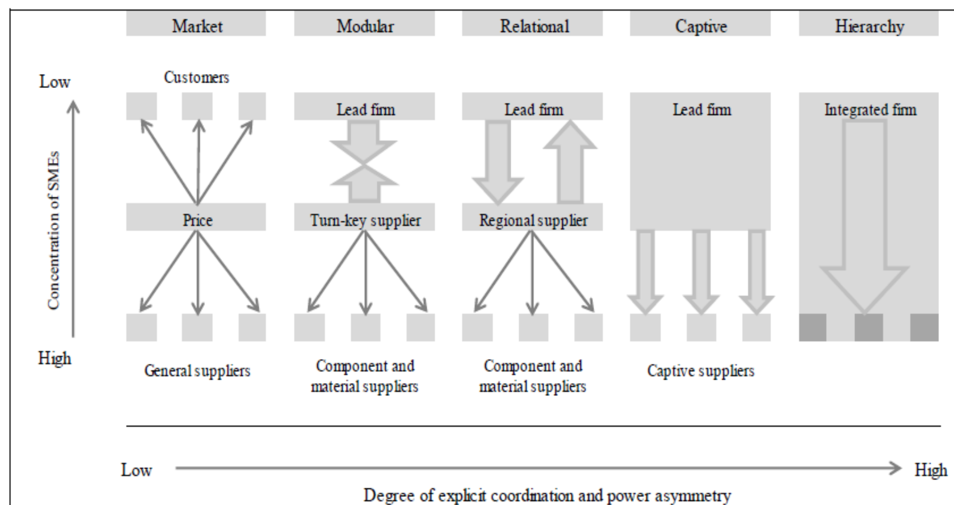
[1] Kaplinsky and Morris 2002
[2] Jones Comfort and Eastwood (2005).
[3] Jones and Kierzkowski (2001),
[4] Gereffi, Humphrey and Sturgeon 2005
[5] Extracte from APEC paper no.6 May 2014

Figure 10 Governance Structures of Global Value Chains



Source: (Gereffi, Humphrey and Sturgeon 2003)
Note: ⇨ = exchange based on information and control. ⟶ = exchange based on price.

i- The **market governance structure** is one of the less extreme cases of value chain governance since it is most loosely organized. The suppliers in this structure provide simple standard products which are either raw or with a simple processing procedure. Transactions are price-based, because products are highly standardized and less customer-oriented, and low-end suppliers can be easily replaced. In practice, the market governance structure is like a spot market, numerous producers meet consumers directly, and it requires no transaction-specific investment, therefore no intermediate agents or sophisticated processing of products are involved.

ii- In a **modular governance structure**, the lead firm and the turn-key supplier have complementary competencies in terms of innovation, technology and market frontier. They work closely to develop the product, and then the turn-key firm will be in charge of setting production and product standards, and managing the low-tier component and material suppliers. The product architecture is modular. This chain represents the consolidated value chain in the automobile and electronics sectors, where the first-tier large supplier enjoys a high degree of autonomy and expanded responsibilities.

iii- A **relational governance structure** depicts a more complex link. The lead firm and the regional supplier develop a mutual-dependence relationship based on strengths, reputation, ethnic values, trust level, social and spatial proximity, or even family ties in certain cases. The products in this chain are less codified, which increases the complexity of value chain governance. Face-to-face communication and explicit coordination are in place to ensure the functioning of the relational value chain.

iv- A **captive governance structure** is a quasi-hierarchy link, where the lead firm exerts close control on production. The lead firm specifies product design features and requirements, and small suppliers invest in particular production equipment and machinery

and become specialized in producing parts and components. Due to the high investment made to build production capacity, the suppliers face significant switching costs, and therefore depend on the lead firm and are captive to it.
The suppliers are confined to perform specific tasks with very limited scope, such as assembly, while the lead firm will handle most sophisticated tasks, such as product design, supply chain management, and quality check and control.
v- The **hierarchy governance structure** is vertically integrated. The integrated firm controls the whole production process and its subsidiaries, as well as the local branches that supply raw materials and components. Nothing is outsourced to external suppliers. As the MNC enjoys direct ownership of firms in the value chain, its role is termed as the integrated firm rather than the lead firm. This structure is one of the extreme cases of value chain governance.
Structures I and v are extreme models while ii,iii,&iv are network-style governance which represents a situation whereby the lead firm exercises power through coordination of production vis-à-vis suppliers (to varying degrees), without any direct ownership of the firms. Value chains could be more complex, and have more tiers of suppliers and complicated configurations. Combinations of different structures in one chain are common, especially in sectors like electronics, automobile and aerospace.

3. DISTINGUISHING FEATURES OF GVC.

Apart from the differences in sectors, GVCs differ in their behaviour towards providing added value to their respective economies as well as to the impact they might have on improving job creation and transfer of knowledge. The indicators utilized by the WTO and OECD are measured based on the added value related to imported of materials utilized in the production of exported goods(backward inputs) and domestic materials utilized for the same purpose(forward inputs). The calculation of the added value is based on the Inter-Country Input-Output (ICIO) model allowing the analysis of GVCs from a truly global perspective detailing all transactions between industries and countries for 37 industries.
Other indicators utilized are the level of participation in the GVC, which reflects the added value of imported inputs plus domestic input over the value of exported goods; the length of the GVC chain (i.e the number of stages in the GVC chain) and the distance from final demand (i.e the location of a country in a value chain) Figure 1& 2 below produced by OECD authors of trade paper no.159,2013, illustrate statistical data for the three indicators
Figure 1: Length of GVC by specific industry sector.

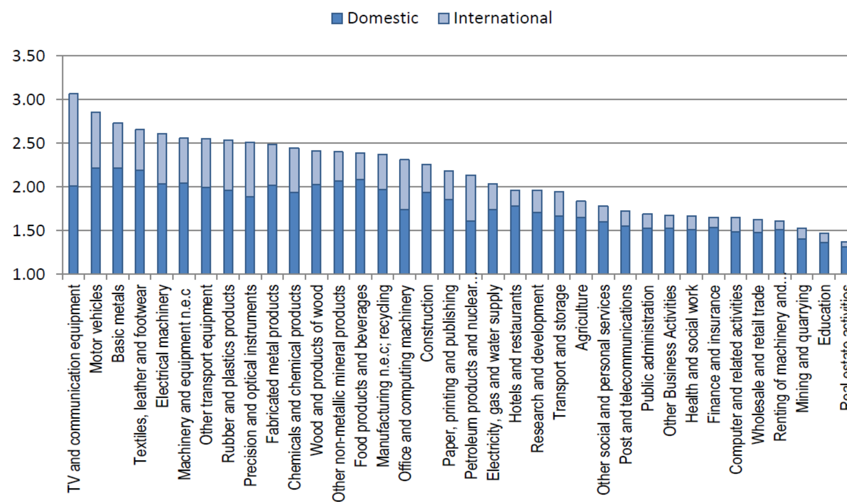
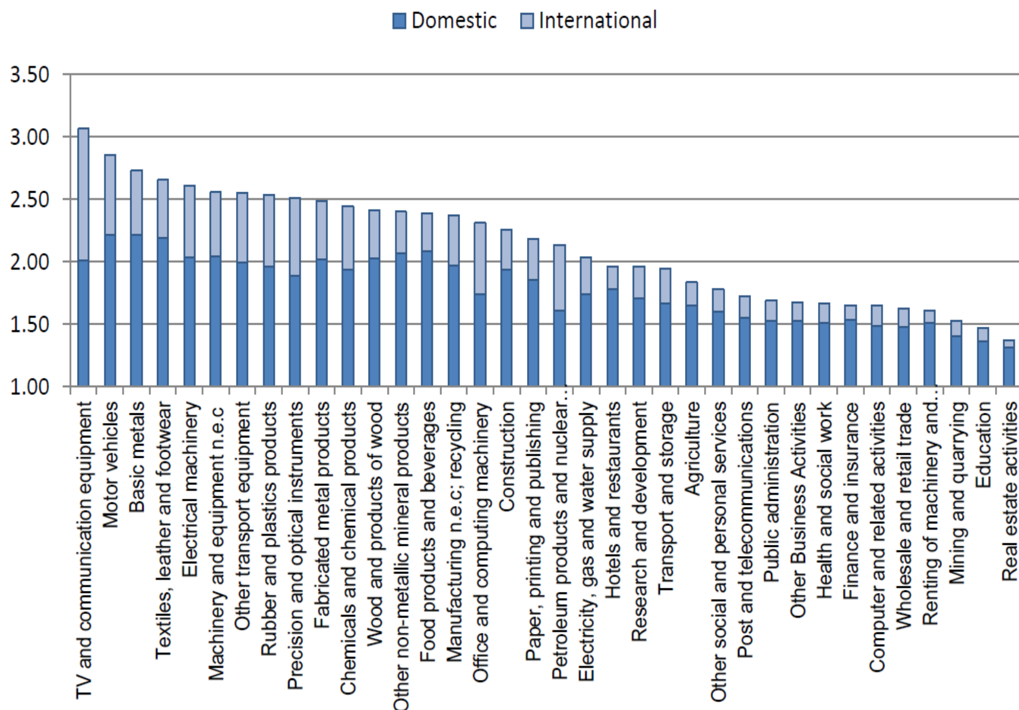


Figure 2: Distance from final demand



4. THE INTEREST OF DEVELOPING COUNTRIES IN GVC

The business strategy of a GVC is usually determined by an MNC, which does not automatically merge with the business interests of a global firm with strategies for the long-term socioeconomic progress of developing countries participating in a GVC.

Therefore the big challenge for developing countries, especially for the smaller and less developed ones among them, and their enterprises are to (1) ensure their progressive movement upwards in terms of value addition in a GVC; (2) enable local enterprises within GVCs to move up the technological ladder; and (3) achieve economy-wide development impacts from integrating into GVCs.[6]

Developing country participation in GVCs is still mostly related to supplying developed countries' markets. Although on the rise, South-South production networks are relatively less developed and mainly limited to East and South-East Asia. Trade in intermediate products within the East and South-East Asia region in 2009 accounted for about 9.6 per cent of world trade in intermediate products (up from about 6.1 per cent in 1993). Similar figures for the East European and Latin American regions are much lower (about 1.9 per cent and 1.1 per cent respectively). **Other regions are lagging behind as their regional trade accounts for less than 0.2 per cent of world trade in intermediate products.**

Although participation in GVCs helped a number of developing countries to expand export oriented industries, in many cases, the value added from such activities did not increase markedly over previous commodity-based exports. To rise along the value chain, an industrial or process upgrading is required.

Gereffi, Humphrey, and Sturgeon (2005) define industrial upgrading a "the process by which economic actors – nations, firms and workers – move from low-value to relatively high-value activities in global production networks".

5. SMEs OF DEVELOPING COUNTRIES TO INTEGRATE VALUE CHAINS

Indeed, integration into GVCs has become an important parameter of the SME policies for export-led development. The GVCs should enable producers within the chain, to obtain modern management Know-how and hands-on information on quality standards and technology; and thus to become more competitive. Such producers also quickly learn about demand patterns in high-income markets and consumer preferences in such markets. Participation in GVCs could also create on the medium term some improvements or positive momentum in areas such as employment, technology and skills, productive capacity and export diversification into more value added. In turn, this momentum would enhance the attractiveness of those countries for more foreign direct investment (FDI). These potential benefits explain the reason why policymakers in many developing countries are keen to address issues over ways to link their private sectors to GVCs;if not well addressed those Trade policies can directly affect the integration of domestic firms into GVCs in two major ways: 1- trade policies can add to the cost of inputs, such as excessive tariffs on intermediate products and 2- Unfavorable market access conditions would put assemblers in a position of relative disadvantage when distributing final products to consumers.

On the other hand the least developed countries (LDCs)have difficulty in participating in knowledge-intensive products which require specialized and reliable suppliers and are operating in sectors where chains are shorter and less technologically intensive; hence the reason why those countries are finding it difficult to shift from low value added segment

[6] UNCTAD GLOBAL SUPPLY CHAINS:TRADE AND ECONOMIC POLICIES FOR DEVELOPING COUNTRIES.2013

chains ; in addition to the fact that the majority of firms in developing countries are small and therefore have difficulty meeting some of the requirements of the GVCs, mainly the operational investment aspect and lack the management expertise for that purpose. Essential elements in the success of the integration process of SMEs are the availability of skilled labor, and technical and managerial expertise; the diversification of exports; sound macroeconomic policies; favorable business environment ;capacity building; economic link to high income markets; sector specific industrial development policies. The knowledge of production processes is one of the keys to industrial upgrading and export diversification. As far as developing countries are concerned, knowledge must come from absorbing it from elsewhere. GVCs can be a powerful force in enabling technology transfers and industrial process upgrading. In this regard, many mechanisms are available, from arm's length technological borrowing to a range of practices that encompass technology licensing, reverse engineering, the injection of equipment and know-how through foreign direct investment; this is to say that Technology transfer within a GVC is not automatic. Lead firms, especially those of products or production technique/processes with high intellectual property content, may restrictively control technical and technological spillover to subcontracted suppliers.
There might be drawbacks form GVC participation if the choice of the lead firm is based on the advantages resulting from insufficient environmental policies or non-core compliant labor laws and that the re-location will merely shift the problem from one developed economy to a developing one.
At the micro level or industry product level, the prospects for SMEs to participate in GVCs are influenced by various factors, such as product quality and price, company attributes, and other external factors.

Product Quality

The product attributes are the top criteria to determine if an SME fits into a specific value chain, and SMEs need to have a correct understanding of the global markets and business of GVCs to produce goods with the right quality, competitive price and capacity for delivery. As noted by the OECD, lack of knowledge about international markets is a major reason for SMEs not to engage in international trade (OECD 2009b). In this regard, governments could set up exchange platforms such as trade fairs, conferences, forums, advisory centers or online platforms, to bridge the information gap between MNCs and SMEs (Conference Board of Canada 2009). SMEs can also collect market information on product quality, price and delivery requirements from this type of exchange; check their products against market trends; and identify their potential competitive strengths to participate in GVCs.

Company requirements

Company attributes reflect the stability and sustainability of SME businesses, which the MNC lead firms would take into consideration when selecting SME suppliers. It includes the financial soundness of the company as well as its production capacities and its moral ethics.

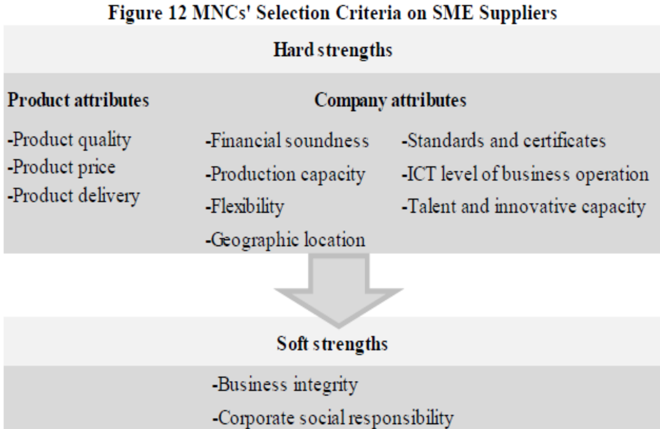
6 . Lebanon participation in GVCs: Type of sectors, level of participation and the potential to boost exports and move upwards in the value chain.

If we considering actual status at the micro level , Lebanon’s GVC participation potential is relatively high, despite the fact that Lebanon is a small country and a small market. Promising sectors include the Agricultural and Agro-food sector, the Apparel and Haute couture sector, the Construction sector, and last but not least the services and creative sectors namely the Banking and insurance sector, Hotel and restaurant sector, the Health care sector, Media and communication sector, the ICT sector and the education sector. Looking at Figure 1 we can realize that most of those sector lie in the small to medium size range; remains to analyze where can we situate Lebanon on the value chains.
Lebanon does not have Raw materials therefore cannot be upstream in the value chain and needs in most of the cases (except for some agricultural products) to import its materials from other firms in other countries. Lebanese SMEs in the majority of the sectors mentioned above, if not all, perform a design and assembly process whereby a finished product or an intermediary product is developed. The
Lebanese SMEs handle quite well their domestic markets, but their potential of growth is highly limited by the size of the market the best way to grow in volume is by addressing other markets; Priorities should be given to neighboring markets but also to markets farther away. Lebanon on the other hand is a small country; it has minimal natural resources and a small market; not very attractive to MNC who prefer to operate in countries with large populations, with low cost labor, with relevant natural resources. Therefore, how Lebanon should become an attractive partner for GVCs?
One possible answer is to focus on what sectors of activities Lebanon has a comparative advantage even if Lebanon does not have a competitive advantage in those sectors. The sectors mentioned earlier in the text can all be potential GVC partnerships nevertheless SMEs in Lebanon will have to abide with certain criteria required by MNC and which can be summarized as follows:

MNCs' Selection Criteria on SMEs

Before entering a business relationship, the MNCs will assess SMEs on hard strengths, such as product and company attributes, as well as on soft strengths, such as business integrity and corporate social responsibility (Figure 12).

Figure 12 MNCs' Selection Criteria on SME Suppliers



Source: Author based on the Conference Board of Canada (2009).

In addition to the specific criteria, external factors are important in facilitating GVC particaption of Lebanese SMEs;

- An adequate Business environment:
  - Open markets
  - Ease of opening a business and permitting or licensing
  - streamlined trading procedures,
  - Complexity of Export-import procedures.
  - High transparency in rules and regulations.
  - Absence of corruption.
  - Environmental and energy policies.
- A suitable Infrastructure:
  - Logistics and transportation are crucial in connecting GVCs. Ports, hubs, roads and railway tracks are physical infrastructure that ship goods, services, and people to different geographic locations.
  - Informational infrastructure links companies across the world, making communication and interaction easily achievable.

Overall, external factors impact on trade costs, hence the competitiveness of GVCs and the long-term success of the MNC–SME relationship.

7. Conclusion

The following matrix provides a quick assessment of Lebanon compliance with GVC participation criteria or good practices. The assessment is based on the EU SBA Assessment report for the middle east and Mediterranean countries as well information on the situation in Lebanon.

Factors	Supporting the participation of Lebanon in GVC		
Internal Factors	Low	Medium	High
Quality of product		x	
Price		x	
Product delivery		x	
Financial soundness		x	
Production capacity		x	
flexibility			x
Standards& certification		x	
Geographic location			x
ICT level of business operations		x	
Talent and innovation			x

External Factors	Low	medium	High
Business environment	X		
Physical and informational infrastructure	X		
Environmental and energy policy	X		
Sector specific external factors	NA		

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