

Chapter 2. Production in Global Value Chains

The globalisation of value chains has changed the way production is organised and has provoked important modifications in the relationships between partners along the value chain. This form of globalisation was determined mainly by the search for efficiency, which includes sourcing inputs from low cost or more efficient producers), the entry in new and growing markets, and the search for complementary and strategic assets. During the past two decades, the organisation of production has therefore undergone a dramatic evolution that has led to new forms of industrial and enterprise organisation on a worldwide basis. Despite the phenomenon being well acknowledged, it is still difficult to measure the extent of the globalisation of value chains. Evidence of this has been observed through indicators of economic globalisation, and notably in the increase of the share of intra-firm exports of affiliates under foreign control, the ratio of imported to domestic sourcing of inputs, and the export and import propensity of affiliates under foreign control in the manufacturing sector (OECD, 2007).

The phenomenon and its drivers

The driving forces of the globalisation of value chains are several, including increased competition, technological progress, especially information and communications technologies (ICTs) development, improved transport facilities, and availability of a large base of low-cost suppliers in areas of the world that experience rapid growth, in particular China and India. In response to these forces and the combined effect of market liberalisation and deregulation, firms have radically changed their business strategies. Multinational enterprises (MNEs) have largely been the source of much of this strategic change towards new organisational forms. Once dominant, the vertical integration model of production has become one among several forms of production organisation that span from mergers and acquisitions, joint ventures, strategic alliances and a variety of co-operative relations. On the basis of empirical studies, many scholars argue that buyer-supplier relations in value chains are increasingly arranged through quasi-hierarchical relationships, which are replacing trade-based and market-based transactions (Gereffi *et al.*, 2005).

Adapting to competitive pressures has implied an increase in the outsourcing of activities. To improve their competitiveness, firms concentrate on core competencies and activities with the highest added value, and outsource non-core activities. Outsourcing of manufacturing tasks, including outsourcing abroad, started long before that of services. Indeed, since more and more countries have developed their industrial capabilities, barriers to entry in manufacturing have consequently fallen and the competitive pressures have heightened. Today, the primary economic returns in the chain of production are typically found in areas outside manufacturing, such as design, branding and marketing, and this has influenced the choice to outsource manufacturing tasks.

Several recent events have reinforced the scope for outsourcing activities and, especially, offshoring them. One of these is the reduction of tariffs in outward processing

trade, which has rendered manufacturing offshore for the home market highly attractive. For many years now, OECD manufacturers have sourced components from other countries, including non-OECD economies. A large base of suppliers has emerged in many non-OECD economies, with China and India having a central role in the panorama of emerging players for their exceptional industrial capacity. Despite geographical distances, improved transport facilities have rendered the outsourcing of production economically feasible. The significant development of product standards has also represented a factor facilitating outsourcing, opening opportunities for competitive SMEs located in different parts of the world.

Some other well-acknowledged factors are the important developments in ICTs, which together with the liberalisation of trade in services have made possible the sourcing, and when feasible the international outsourcing, of numerous service activities based on “knowledge work” such as data entry and information processing services, research and consultancy services or services that can be easily carried out through ICT-enabled service provision such as call centres (Van Welsum and Vickery, 2004).

Moreover, the scope for service offshoring is augmented by the fact that business services represent a larger share of production costs. This increases the pressure to seek lower-cost solutions for their provision. Finally, the ICT and related skills shortages experienced in many OECD countries in the late 1990s (Van Welsum and Vickery, 2004) and considerations concerning taxation (Gage and Lesher, 2005) provide additional reasons for service offshoring.

A much less discussed determinant in the choice of offshoring, and of organisational changes in general, is the role of finance. Ponte (2003) has argued that the “pressures on enterprises’ boards to maximise shareholder value have been one main factor entailing restructuring operations, externalising non-core activities, re-engineering supply chains to match a set of financial indicators, most importantly the ratio of post-tax return on capital employed”.¹ This pressure has brought about a shift from competitive strategies based on maximising the market share to strategies aimed at maximising financial performance.

Box 2.1. Outsourcing and subcontracting

Firms can source activities to affiliate companies (in-house sourcing), or outsource them to external suppliers. In both these cases, they can refer to firms domestically or abroad (offshoring) (see Van Welsum and Vickery, 2004, for a representation of sourcing in terms of a matrix of location and control).

Subcontracting corresponds to production outside the enterprise. It takes place between non-affiliate firms, although often in a relationship of co-operation or partnership. In the case it occurs outside the country of the contractor, this involves foreign subcontracting (offshore outsourcing or subcontracting abroad). According to the definition in the OECD Handbook of Economic Globalisation Indicators, “subcontracting occurs when one firm, the prime manufacturer or contractor (principal), contracts with another firm, the subcontracting or supplier, for a given production cycle, one or more aspects of product design, processing or manufacture, or construction or maintenance work. The supplier must adhere strictly to the contractor’s technical or commercial specifications for the products or services in question”. Also, the same firm can be a subcontractor for some customers and a prime contractor for other, smaller firms.

Subcontracting abroad does not involve direct investment, while the transfer of production abroad (called “relocation”) through affiliates companies implies FDI.

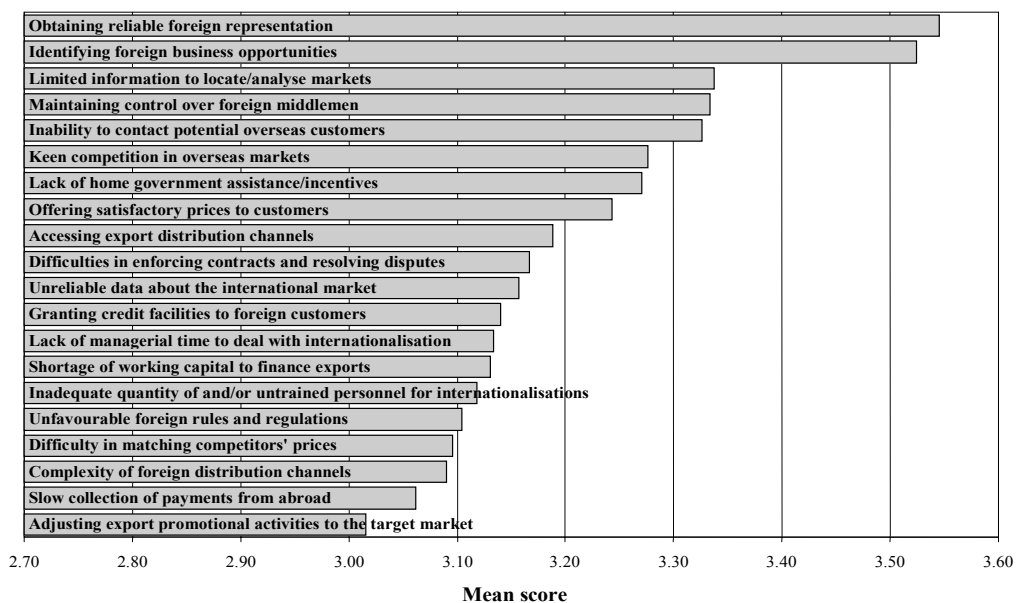
Source: OECD Handbook of Economic Globalisation Indicators, 2005.

Today, the phenomenon of offshore outsourcing is at the centre of an economic and social debate and a matter of concern for workers in OECD countries. Although little empirical evidence is available so far in showing the actual dimension of offshoring of IT or ICT-enabled services, service offshoring has raised a case for policy intervention (Brainard and Litan, 2004). While the costs, in terms of employment, are at the core of the debate on outsourcing, the benefits derived by increased firms' competitiveness in OECD countries and price reductions for consumers are not completely acknowledged. This is, in part, due to the fact that the cause-effect relationship is less evident and also because of the delay with which the benefits may become manifest (Hatzichronoglou, 2007).

Opportunities for SMEs

SME participation in global value chains has to be placed in the broader context of SME internationalisation. The reorganisation of production at the international level and the development of global value chains are having significant effects on SMEs, in particular by expanding their business opportunities. In general, reaching international markets is a problematic step for SMEs. A recent OECD-APEC survey, carried out in the context of the study "Removing Barriers to SME Access to International Markets", investigated the type and intensity of barriers in accessing international markets perceived by SMEs. The survey found that these firms feel that their full participation in the globalisation process is hampered by numerous internal and external obstacles (Figure 2.1).

Figure 2.1. Obstacles to internationalisation as perceived by SMEs



Note: SME Survey carried out between January and July 2006. Responses received from a total of 978 SMEs in OECD and APEC economies, with a high degree of concentration within just seven OECD member countries: Canada, Greece, Switzerland, Turkey, Japan, Spain and New Zealand. Barriers are ranked using the Likert-Scale ranking method, from 5 (very significant) to 1 (not significant).

Source: OECD WPSMEE (2006), "Removing Barriers to SME Access to International Markets".

It seems that SMEs consider their internal capabilities and resources as inadequate, and lack self-confidence in approaching international markets, as expressed by their perceptions of obstacles such as difficulty in identifying foreign business opportunities, maintaining control over foreign middlemen or accessing export distribution channels.

In particular, in developing countries, only a limited number of SMEs are well prepared for the new conditions and increased competition encountered in global markets, thus limiting those who benefit from the opportunities opened up by globalisation (UNCTAD, 2005). On the contrary, trade liberalisation increases the ability of well-established foreign manufacturers and retailers to penetrate remote and underdeveloped markets, and makes it increasingly difficult for SMEs in developing countries to survive or at least maintain their business position in the local and, if applicable, global market. An emerging opportunity to reap the potential benefits of global trade is represented by the integration of SMEs into global chains of production at various stages of added value, through the establishment of linkages with larger firms and foreign affiliates. These linkages may represent the way for the SME sector, or at least for the segment with the highest growth potential, to access a series of missing critical resources, the most important of which are access to international markets, finance, technology, management skills and knowledge, and to engage in a mutually beneficial relationship. In this respect, it is worthwhile noting that in the past developing countries have succeeded in complex industrial exports without going through MNE networks, by building the necessary indigenous base of technological capabilities. However, the changing international context and the growing role of MNEs in production and trade suggest that much of the growth of exports in the future will be situated in or around MNE production systems (UNCTAD, 2004).

Accessing new markets, entering new product and service niches

In both industrialised and developing countries, two phenomena have characterised the past decades and contrasted the impact of actual or perceived barriers to SME access to international markets. First, the use of ICT-technologies and related services and improved transport facilities have importantly contributed to overcome SME isolation and ease small firms' access to markets well beyond national boundaries. Previous OECD work, which analysed the extent of diffusion and uptake of ICT technologies among SMEs, highlighted the benefits of ICT use for these firms in terms of extending their network of business partners and reaching new customers with greater ease and at lower costs (OECD, 2000).

Second, the fragmentation of production together with the development of ICT-technologies creates new entrepreneurial possibilities for SMEs. New niches for the supply of novel products and services continuously emerge where the small firms can position themselves, exploiting their flexibility and their ability to move quickly. Small firms with quality tangible and intangible assets, such as niche products and advanced technologies, are becoming partners in international strategic alliances, targets of cross-border mergers and acquisitions, specialised suppliers to MNEs, and participants in actual and virtual business networks on a global level (Sakai, 2002). In manufacturing sectors such as automotive and precision and scientific instruments, small firms which focus on multipurpose technologies have secured their position in the market by becoming specialised suppliers serving different global value chains.

The considerable spreading of subcontracting has benefited SMEs. It has opened business opportunities and brought more stability in the volume of work. Participating in

global value chains as subcontractors also provides indirect access to global markets at lower costs than those faced by individual small-scale producers, due to the intermediary role assured by the contractor. Another advantage is exposure to learning processes among partners in global production networks (for instance, from the dissemination of business concepts) and this offers possibilities for human and technological capital upgrading. Although subcontracting *per se* does not necessarily imply much co-operation between the two parties, some tasks do demand a significant amount of co-operation in order to be fulfilled.

There are different profiles of subcontractors (Box 2.2), with an important phenomenon being the increasing complexity of tasks required from subcontractors in several industrial sectors. The evolution in subcontracting relationships between large firms and their smaller counterparts in recent decades is illustrated in Figure 2.2, with reference to Japanese firms.

Box 2.2. Subcontractors

Different profiles of subcontractors can be identified in particular on the basis of their production capabilities. OECD (2005) and Hatzichronoglou (2005) distinguish two main categories of subcontracting that give rise to different relations between prime contractors and suppliers.

The first category concerns relatively commonplace goods and services with a low technological content (e.g. call centres, catering, intermediate inputs for various kinds of machinery, etc.). Because the base of suppliers in this category is wide, prime contractors can exert strong pressure on prices and delivery times, and replace their subcontractors relatively easily.

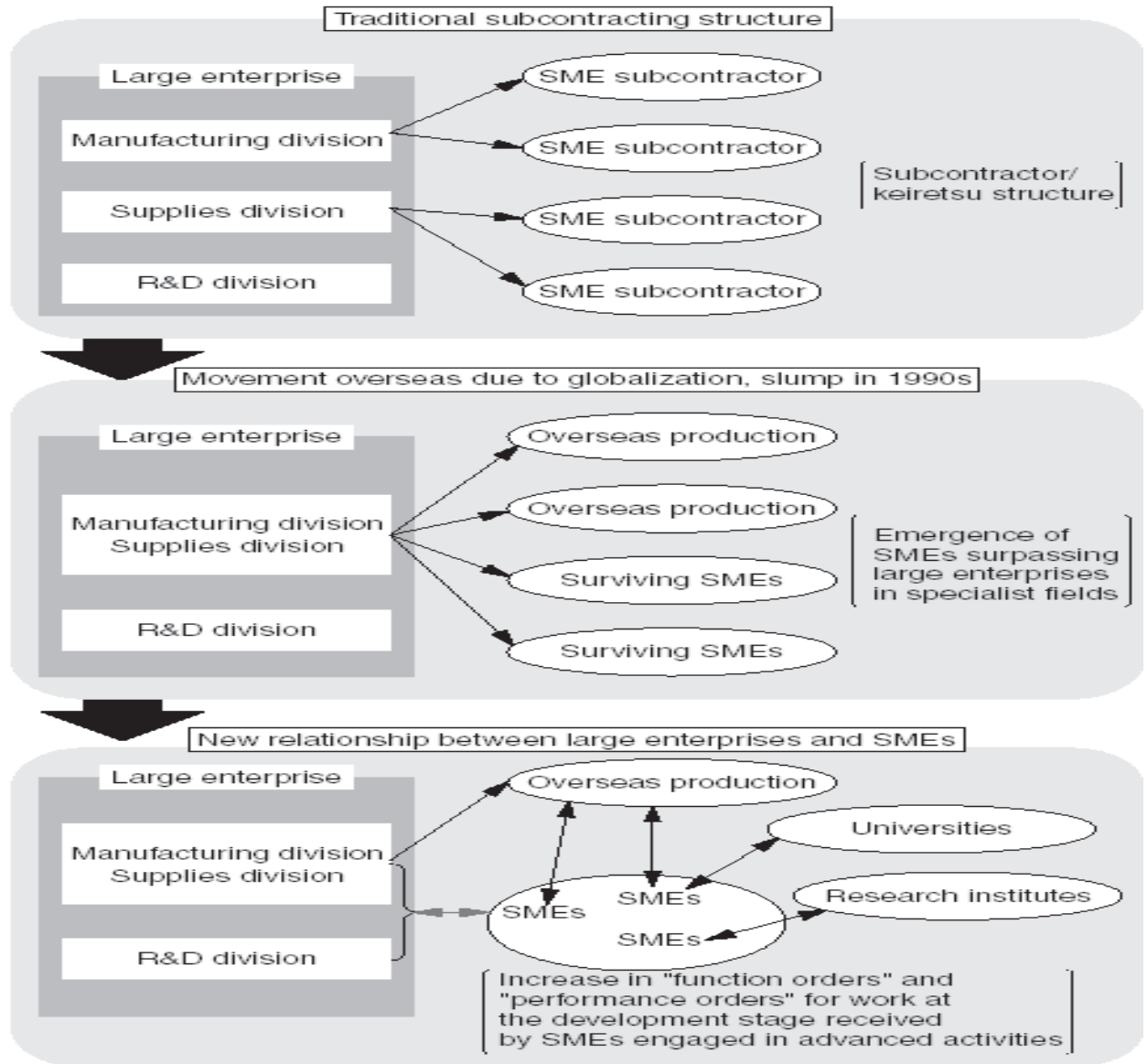
The second category involves goods and services with a high technological content, and that are generally the subject of constant innovation. Suppliers in the second category are more closely associated with the design of the products, and thus assume a role similar to that of a partner. A typical example of this type of subcontracting (also called “subcontracting partnership”) are the relations between automobile or aircraft manufacturers and their respective parts suppliers. Both these cases generally involve high-tech goods for which suppliers cannot be mere executing agents but must also participate in the design of products and monitoring technological developments, sometimes even imposing certain innovations on the prime contractors. For this reason, contractors in the second category are much more dependent on their subcontractors than prime contractors in the first category.

Despite the close links that might tie prime contractors and their subcontractors, especially in the case of high-tech goods, their relationships differ from co-operation agreements. In co-operation agreements, partners often establish financial links between them (mutual capital investment) and seek through their co-operation to share costs and risks, notably in research and development, or they undertake co-operation to jointly develop a new technology.

Source: OECD Handbook of Economic Globalisation Indicators, 2005.

Electronic marketplaces: Electronic B2B marketplaces are a tool used by large and multinational firms to manage orders to suppliers and subcontractors and the flow of information with them. They can be vertically focused on particular industries, or they can be horizontally focused to provide goods and support services across a wide variety of industries. During the past decade, many large companies have set up their own electronic trading platforms to procure goods and services, while others are using third party e-marketplaces. For all of these firms, the objective is to better control their supply chain and rationalise cost and information at each stage of the chain.

Figure 2.2. Changes in subcontracting structure, Japan



Source: Japan Small Business Research Institute (JSRBI) 2005 White Paper of Small and Medium Enterprises in Japan.

The use of e-marketplaces seems to be predominantly buyer driven. SMEs are under increasing pressure to use e-marketplaces as a condition to continue supplying their traditional customers. SMEs have to partake in reverse auctions² using their customers' e-marketplace, but they find it difficult to assess whether the buyers' priority is reducing the price level or gaining efficiency in terms of improved process time. Evidence on the outcomes from participation in auctions and SMEs' perception of this tool is mixed. Some suppliers consider e-marketplaces as tools for the buyers to limit prices by looking for new suppliers (Kjøseth, 2005). This is consistent with another finding of recent research in this area, namely that buyers are often not willing to invite suppliers with whom they already have a long-term relationship to e-marketplaces. However, there is also evidence that a very large share of online auctions is awarded to the existing

supplier. Also on the positive side, some SMEs recognise that participation in e-marketplaces has allowed them to increase their global exposure and to secure contracts that they otherwise may not have received.

Box 2.3. Electronic marketplaces: the case of Covisint

In the automotive industry, the suppliers face increasing collaborative pressures to develop the ability to manage project-based co-operation and provide leading-edge technology, particularly first tier suppliers who are taking over from Original Equipment Manufacturers (OEMs) the responsibility for systems integration and the management of the supply chain.

Electronic Data Interchange (EDI), launched more than 30 years ago, was the first step of the automotive industry to closer collaboration with its suppliers by means of inter-organisational systems. Until the advent of open, cheap and flexible standard based Internet-related technologies during the late 1990s, EDI was the dominant standard in the area of B2B e-commerce. However, the high costs associated with the implementation and use of EDI meant that only large suppliers became involved in this system. During the late 1990s, the automotive industry launched a strategic programme to ensure the networking of the entire value chain beyond the company's boundaries, with the final objective of integrating all the specific applications into a global supplier portal. This would have not only reduced costs but also increased the efficiency of information and data exchange, taking advantage of leading-edge technology. In 2000, an Internet hub called Covisint was created by large OEMs such as GM, Ford and DaimlerChrysler and software companies such as Oracle.

The founders' aim was to connect the automotive industry to a global exchange marketplace by streamlining the business processes of all participants and enabling them to collaborate "seamlessly" across organisations' borders. The reaction of suppliers was not what was expected. Indeed, despite the acclaimed aim of Covisint to reduce costs and risks across the industry, SMEs felt that only the requirements and vision of the large OEMs were taken into account in the development phase, and not that of the entire industry.

Source: Gerst et al., 2005.

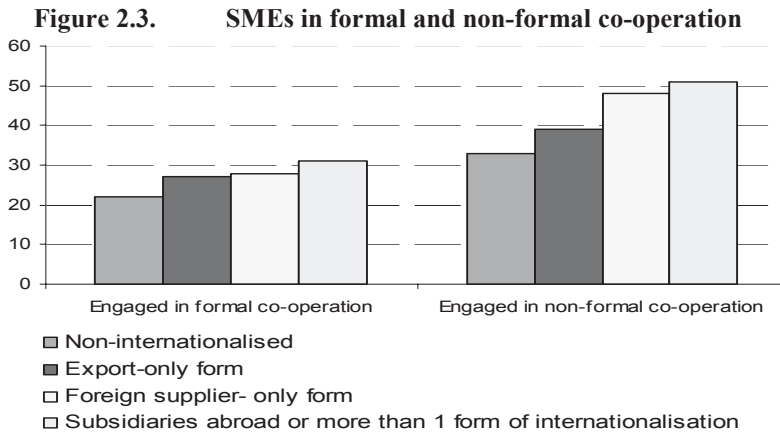
Overall, SMEs are still reluctant to use e-marketplaces, partly due to a lack of awareness, although many real barriers may also prevent them from fuller participation. According to recent research, SMEs find it difficult to judge which of the many e-marketplaces to trust and how one type of e-marketplace distinguishes itself from another (for instance, vertical versus horizontal e-marketplaces) (European Commission, 2002; Kjølseth, 2005). Different standard requirements for products and services are another obstacle since this raises the entry cost to participate in different e-marketplaces, which can be already relatively high for small firms. Finally, many small firms are worried about unfair business practices such as price fixing in online auctions.

Rationalising production: offshore outsourcing and acquisition of strategic assets

With the development of ICT technologies and the emergence of a global supplier base, outsourcing, including offshore outsourcing, has become a viable option also for small firms. As common with large firms, SMEs increasingly choose to outsource tasks when this allows them to gain competitiveness from the rationalisation of production and the optimisation of resource allocation. In many cases, it is the decision to follow the contractors abroad that determines the offshoring strategy. While difficult to measure, the increased recourse to outsourcing and offshoring by SMEs has been recorded in recent SME surveys (2003 Observatory on European SMEs; and Japan's 2004 and 2006 White Paper on SMEs). Recent studies from UNCTAD (2005) revealed that even SMEs in

developing countries and economies in transition increasingly try to enhance their competitiveness through FDI that provides them with access to strategic assets, technology, skills, natural resources and international markets.

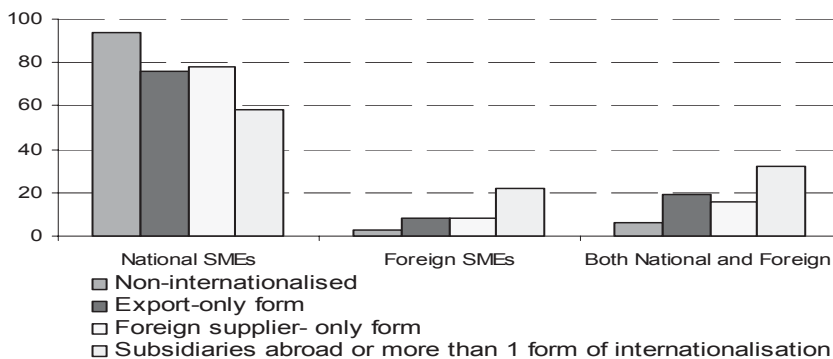
A European survey carried out in 2003 found that more than one third of the surveyed SMEs with subsidiaries abroad had no exports (European Commission, ENRS Survey 2003). This suggests that the creation of foreign subsidiaries by SMEs is not always intended as a sales platform for the company's products but can also be a platform for accessing cheap labour (*e.g.* via sub-suppliers) or accessing knowledge and technology. The survey findings also indicated that internationalised SMEs are more prone to co-operation whether by formal (such as agreement or contract) or informal terms with other firms, both domestically and abroad, as compared to other non-internationalised small firms (Figures 2.3 and 2.4).



Note: The ENRS survey groups the surveyed SMEs according to the following forms of internationalisation: 1. foreign supplier (importing) as the only form of internationalisation; 2. Exporting as the only form of internationalisation; 3. Subsidiaries, branches and joint ventures abroad, or a combination of more than one form of internationalisation. The figure shows percentages for each typology.

Source: EC, ENRS Enterprise Survey 2003.

Figure 2.4. National or foreign SMEs as important partners in co-operation

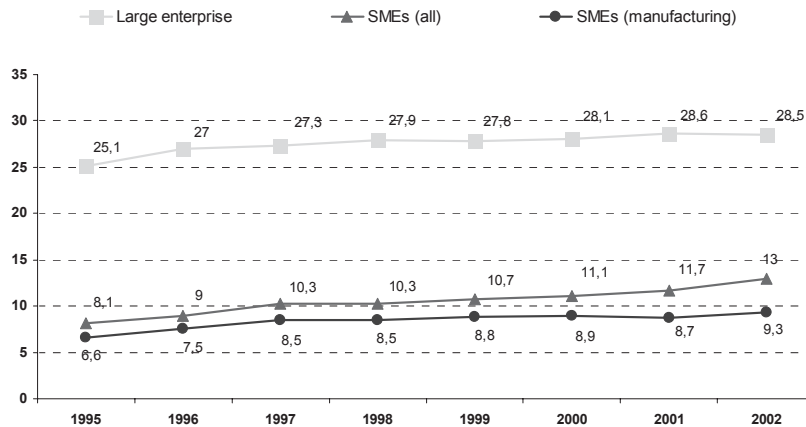


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Source: EC, ENRS Enterprise Survey 2003.

In Japan, the proportion of SMEs with overseas subsidiaries has increased constantly since the beginning of the 1990s, in particular in manufacturing (Figure 2.5). The purposes of establishing subsidiaries change according to region, with sourcing cheap products and cutting costs being the first reason in China and in newly industrialising economies (Hong Kong, Chinese Taipei and Korea). At the same time, the increase in foreign direct investment has also been accompanied by a rise in the number of withdrawn overseas subsidiaries of SMEs, with a higher share of withdrawal for joint-ventures than for independent ventures. This is probably a sign of the difficulties SMEs encounter in managing operations outside their domestic market (OECD, 2005a).

Figure 2.5. Proportion of Japanese companies with overseas subsidiaries



Source: Japan's 2004 White Paper on SMEs.

Typically, small firms estimate that the savings associated with offshore sourcing are likely to be outweighed by the cost and risk of establishing an offshore operation. The difficulty of managing outsourcing of activities in countries with different languages and cultures may represent a barrier to SMEs. Despite these problems, recent empirical evidence showed that SMEs can be successful in outsourcing abroad (Value Leadership Group, 2005). These SMEs have adopted an overall strategy with respect to outsourcing that goes beyond cost cutting. Indeed it is not easy to gain a competitive advantage based solely on a cost advantage, because competitors soon or later are forced to follow an offshore strategy. SMEs that have been successful are those that choose overseas partners with complementary competencies and a qualified labour force, thus adding their comparative advantage at home and that of their partners. Among European IT SMEs, those successful in outsourcing offshore marked a step towards restructuring the firm's business model that allowed it to stay in the market and even remain competitive.

Challenges for SMEs

Overall, the globalisation of value chains constitutes a major challenge for small and medium-sized subcontractors used to serving local and national markets. Even when SMEs do not follow their contractors in international markets but stay at home, they still feel compelled to conform to those international standards for technology, quality, delivery and after sales service that evolve in their industry. Also, small subcontractors have to adapt routines and practices developed at the local and/or cluster level to managerial practices set by international buyers.

Also, network relationships have gained importance in global value chains (GVCs) as a mechanism of co-ordination between firms, whereas co-ordination was once more polarised between market-based relationship on one side and vertical integration (where a firm segments its activities along a number of domestic or foreign affiliate companies) on the other. The critical feature is that this type of relationship between a firm and its suppliers is not based on ownership, but nevertheless implies a degree of co-ordination which can be very high. Network relationships comprise a spectrum of possibilities going from low to high levels of co-ordination and power asymmetry between buyers and suppliers.³ Relying on factors such as the ownership of brand names, proprietary technology, or the exclusive information about different product markets, lead firms act as governors of the chain by setting the conditions of the participation of the other agents in the chain. These would include, typically, process and product standards, quantity and terms of delivery (Humphrey and Schmitz, 2004).

For an increasing part of manufactured and semi-manufactured goods and services with a medium to low technological content, contractors have now a large base of suppliers available. For these products, the costs of changing suppliers are not high as compared with the situation for non-standard and high-tech products that are associated with a degree of specialisation and customisation that increases agency costs. Evidence suggest that many SMEs in OECD countries have registered a decrease in the orders by their main buyers that choose to subcontract abroad where lower cost conditions can be found (see, for instance, Japan's 2005 White Paper on SMEs). For some small companies, this has implied the closure of their business.

The parallel phenomenon of increased outsourcing of customised inputs or services, for which agency costs are an issue, raises a different range of problems. In some cases, a supplier may need to make significant investment to develop relationship-specific assets necessary for the transaction. For instance, a part that a seller customises for a particular buyer is a specific commodity and any investment that the seller must undertake specifically as a result of the customisation is a relationship specific asset. The need for relationship-specific investments in different global value chains might create a situation where some suppliers, especially small firms, become captive to the buyer. In France, 85% of the respondents to a survey of subcontractors in the automotive sector declared to be unsatisfied with the prevailing market prices, which they consider as too low (Usine Nouvelle, 2006). They reported that the cost reduction asked by contractors has been between 10% over one year and 20% over three years.

In other cases, a firm's participation in a global value chain might imply downgrading its functions in order to respond to the conditions imposed by the lead firm. For example, SMEs in one of the most reputed Italian shoe clusters have accepted to focus only on manufacturing and abandon conception and design tasks (Rabellotti, 2003). Although these firms succeeded in remaining competitive in the global market compared to other competitors, the effects of the functional downgrading in the medium and long term need to be evaluated, in particular if this is associated with loss of local skills.

This problem illustrates the difficult choices that the SME may have to face when exposed to the international market. The market structure on the international stage may not necessarily be the same as at home. For example, at home, the SME may be a supplier to a market of many similarly sized buyers. However, with international exposure comes possible entrance into an oligopolistic or monopolistic market (*e.g.* Wal-Mart and its suppliers). While the decision not to sell to the dominant buyers in these markets may mean a substantial loss in potential sales and profits, the decision to deal with the

dominant buyers can result in reduced profit margins due to asymmetries in contract negotiation and a loss of control in production decisions.

Supplier financing

The participation of small firms in global chains is also challenged by the fact that these firms may find it difficult to finance their production cycle, since after goods are delivered most buyers demand 30 to 90 days for payment. Specific financial tools such as “factoring” and “reverse factoring”⁴ have been created to provide financing to small suppliers. In Mexico, the Mexican Development Bank has promoted a supplier financing programme based on reverse factoring, which links large private and public companies and their SME suppliers (Box 2.4).

Box 2.4. Providing financing to small suppliers

In March 2003, the Inter-American Investment Corporation (IIC) signed an agreement committing USD 20 million to a guarantee programme for supply chain financing with Nacional Financiera (NAFIN), Mexico’s largest state development bank, which is active in providing financing to small enterprises that supply goods and services to public sector agencies and first-tier companies.

The guarantee programme intends to channel up to USD 200 000 per beneficiary to small suppliers of first-tier companies operating in a variety of productive sectors throughout Mexico. The programme is expected to reach between 500 and 800 beneficiaries during its projected seven-year life. Accordingly, the programme should contribute to the creation of an estimated 2 500 to 4 000 jobs, in addition to generating annual export revenue valued at between USD 15 million and USD 25 million.

Source: IDB –IIC website

Developing countries’ perspective

In developing countries, local component firms are finding it increasingly difficult to withstand the pressures of global sourcing. The pervasive pressure on MNEs to reduce their number of suppliers has the effect of removing many developing countries SMEs from the supply chain. In producer-driven GVCs, in particular in the automotive, capital goods and electronics industries, this is the source of continuously declining local ownership. For example, data show that the auto component sector is uniformly changing, from locally owned firms using local technology, to suppliers using proprietary technology from one of the global first-tier suppliers, preferably within an FDI relationship (Kaplinski, 2004). In this case, the challenge for an SME is typically how to engage with second- or third-tier suppliers, as first-tier suppliers are usually large multinationals in their own right.

The company case studies carried out in the automotive sector in India and South Africa show that large opportunities in second-tier sourcing have consistently emerged. To a large degree, independent local suppliers seem not to have managed to either link with global sourcing partners or build their own capabilities and resources to become a global sourcing partner. On the other hand, developing countries’ SMEs are increasingly working with global sourcing intermediaries that operate as first-tier suppliers of large MNEs. In this respect, there is a strong and urgent need to upgrade local suppliers and respond to the expectations of MNEs in terms of product quality standards, supply standards and delivery times. Suppliers to Toyota in South Africa, for example, agreed that mere proximity to the local plant, the ability to produce a component according to a

supplier specification and a history of relationship does not necessarily guarantee an ongoing relationship with Toyota (UNCTAD, 2006).

Today, in developed and developing countries it is critical that firms meet specifications in international standards and systems and provide their own technology offering or that of a strategic partner in meeting future production demand. The quality of the relationship between international contractors and their partners and suppliers is also crucial. In some developing countries, specific programmes have been set up to facilitate SME integration in global value chains, building on the linkages between MNEs and SMEs (Box 2.5).

Box 2.5. Facing the challenge of global value chains: SMEs in developing countries

The establishment of sustainable linkages between SMEs and MNEs is one of the most effective ways to integrate domestic suppliers into GVCs. Not all developing countries, however, have been successful in promoting such linkages, and in embedding foreign firms into the local economy in the long term. The analysis of successful business linkage programmes shows that building linkages is dependent on the broader economic, social and cultural environment. Additionally, it shows that the creation of SME-MNE linkages is neither easy nor automatic, and that in developing countries a systemic policy approach to linkage building has produced positive results.

For example, the main objective of the business linkage promotion programme in Uganda is to promote the creation of durable and mutually beneficial partnerships between MNE affiliates and large local companies on the one hand, and SMEs on the other, so as to enhance the productive capacity, efficiency, competitiveness and sustainability of their relationships. The programme is being implemented by a Business Development Services Centre as lead facilitator, namely Enterprise Uganda, in collaboration with the Uganda Investment Authority (UIA) and supported by UNDP, UNCTAD, and the Government of Sweden.

The key role of each partner is as follows: Enterprise Uganda identifies SMEs and brokers and facilitates implementation of business linkage deals and defines SMEs' capacity gaps. It also ensures the transfer of technology and know-how including coaching and mentoring of SMEs by MNEs, and facilitates access to markets and finance. The Uganda Investment Authority contributes to the improvement of the business policy environment and facilitates the initial brokering of the linkages with the MNEs.

The project so far demonstrates that in spite of the productive capacity constraints of SMEs, MNEs were ready to upgrade their business relationships with SMEs into long-term relationships, provided SMEs committed themselves to remedying shortcomings in their business systems, and upgrading their skills. Since its inception in 2005, the project achieved the following results:

- An agreement has been signed with Uganda Breweries, which will assist in the upgrading of the members of the barley growers' association in Eastern Uganda, to benefit over 2 000 farmers.
- In Western Uganda, Kinyara Sugar Works Limited under Booker Tate signed an agreement to strengthen its link with Kinyara Sugarcane Growers Limited, thereby benefiting about 2 500 local farmers.
- In the telecommunications sector, two telephone companies have signed up to upgrade their distributor network.
- In the real estate sector, the country's biggest real estate developer has signed an agreement to support 15 local suppliers.

Source: UNCTAD, Developing Business Linkages, 2006

Notes

1. Ponte (2003) makes the example of roasters (the lead firms in the coffee value chain): the firms that are quoted in the stock exchange will be under pressure to externalise inventory management to reduce stockholding, while those privately-owned may find it profitable to hold stock. This may explain different organisational forms of firms that are at the same point of a value chain.
2. A reverse auction is an electronic auction where suppliers bid online against each other for contracts against a published specification.
3. Gereffi *et al.* (2005) observe the emergence of networks as a predominant form of co-ordination (or governance) between firms in value chains; they distinguish, in particular, three types of network relationships: modular, relational, and captive.
4. Factoring is a type of supplier financing in which firms sell their credit-worthy accounts receivable at a discount (equal to interest plus service fees) and receive immediate cash. There is no debt repayment and no additional liabilities on the firm's balance sheet, although it provides working capital financing. Factoring is not a loan but a comprehensive financial service that includes credit protection, accounts receivable bookkeeping, collection services and financing. In reverse factoring, the lender purchases account only receivable from high-quality buyers (*i.e.* large internationally accredited firms) so that the credit risk is equal to the default risk of the buyer and not that of the SME (Kappler, World Bank, 2004).

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