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**PANEL II
SMEs AND CLUSTER INTERNATIONALISATION**

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PANEL II: SMES AND CLUSTER INTERNATIONALISATION

Clusters of small- and medium-sized firms (SMEs) have been recognised as motors of economic growth and innovation for national economies (Bologna Charta, OECD 2000). This issue paper wants to discuss the potential of SME internationalisation through clusters by highlighting the challenges and prospects of SME and cluster internationalisation both for OECD and non-member countries. After briefly discussing the importance of SME clusters for national economies, the phenomenon of SME and cluster internationalisation and its impediments will be introduced. Furthermore, the trend to cluster internationalisation will be presented as a potential strategy for SMEs to cope with the demands of globalisation touching upon the benefits and potential pitfalls. The paper concludes with a range of questions to stimulate the debate during the workshop on SME and Cluster Internationalisation.

THE IMPORTANCE OF SME CLUSTERS FOR NATIONAL ECONOMIES

During the last decade a paradigm shift occurred: It is now widely recognised that SMEs are a critical driver of employment growth both in OECD and non-OECD countries. Policymakers realised that SMEs were uniquely positioned to answer to the challenges of an ever faster globalising economy.

SMEs have been able to compete with bigger national and international competitors by clustering together to achieve economies of scale and scope. These clusters, loosely defined as geographically concentrated firms of different sizes horizontally and/ or vertically linked and operating in the same line of business attract the interest of both policymakers and academics: They not only account for a sizeable percentage share of national GDP and exports, in some cases, they also function as hotbeds of innovation and learning. Given the economic importance of clusters, they were recognised as tools for economic development and for upgrading of international competitiveness of national industry (OECD 2000).

Globalisation, and the associated phenomenon of intensified international competition affects SMEs around the globe. One strategy for SMEs to respond to competitive pressure is to cluster together in order to survive. As economies become more and more intertwined by the exchange of goods and information, SMEs and SME clusters increasingly establish links with the international economy. The following paragraphs introduce the phenomenon of SME and cluster internationalisation and some of its impediments.

SME AND CLUSTER INTERNATIONALISATION

The strive to gain international competitiveness acts as an incentive for SMEs and clusters to look for opportunities abroad making use of the advantages related to their size and flexibility.

Internationalisation is a process in which firms based in one country become active in more than one other country. Hence, SME internationalisation describes a phenomenon where co-operating firms are either located in different countries and/ or operate across national boundaries to be present on international markets. SMEs can ‘go international’ in various ways: They may become part of an international value-added chain, they may outsource part of their production process to third countries, they may seize business opportunities by spreading across borders or form international networks to exchange information or to strengthen their presence on foreign markets, to name just a few possibilities. Clusters, where they exist, can help SMEs overcome some of the barriers to internationalisation.

Cluster internationalisation can either describe the strategy of a single firm inside of a cluster to look for opportunities abroad or a concerted effort by a cluster as a whole to internationalise in much the same fashion as described above.

Whether SMEs as individuals or clusters as a whole choose to seize the opportunity to become active in more than one country by looking for partners abroad, or whether SMEs and clusters compete for a niche position in an international value chain, they are confronted with a range of difficulties in the process. In the following, potential obstacles to SME and cluster internationalisation will be presented.

Impediments to SME Internationalisation – Impediments to Cluster Internationalisation

Geographic boundaries are big impediments to SME internationalisation. By crossing their national threshold, SMEs have to operate in an unknown and often intransparent economic, juridical, political and cultural environment, which makes international endeavours an often costly undertaking. The costs incurred can be prohibitive given SMEs’ notoriously over-stretched resources and their already difficult access to capital. Special costs associated with internationalisation relate for example to informal trade barriers, such as lack of information on business opportunities and weak international contract enforcement. In addition to search and contract enforcement costs, there is the huge burden of financial risk, such as export financing exposed to fluctuating currencies and price (exchange rate risk) and credit risk when dealing with international business counterparts.

Main Barriers to SME Internationalisation:

- Informal trade barriers (lack of information on business opportunities, weak contract enforcement)
- Financial burden (exchange rate risk, political risk, credit risk)
- Cultural barriers
- Foreign regulatory environment
- Lack of domestic support structure (financial support, advice)

Even in areas where countries are linked together by free trade agreements or by a legal framework creating a common market such as the EU, barriers to SME and SME cluster internationalisation stubbornly persist. A study of the European Union (European Commission 2002) reveals a number of cross-border regional clusters such as the Öresund region in Denmark and Sweden (pharmaceuticals and medical equipment) or the Twente region along the Dutch-German border (plastic and metal processing). The barriers to increased cross-border co-operation have been identified as relating to differences in legislation, namely the labour market, education and research, infrastructure and logistics, to name just a few. However, intangible factors such as differences in culture and a lack of shared identity prove as cumbersome, if not more difficult to overcome as incompatible pieces of legislation.

If the birth and survival of successful clusters is often fraught with difficulties in one single country, to bring about the same feat at a transnational level takes enormous patience, especially in order to establish a relationship of trust among cluster firms across cultural and linguistic barriers. In addition

to traditional barriers to market entry or impediments to operate in a foreign environment described above, another crucial factor therefore stands in the way of cluster internationalisation. Is not the 'social glue', the common identity holding a cluster together contingent upon physical proximity of all cluster members?

Main Barriers to Cluster Internationalisation:

- Cultural and linguistic barriers
- Geographic distance between cluster members
- Communication among cluster members
- Spread of knowledge and innovation
- Establishment and upkeep of cluster identity
- Absence of common pool of specialised labour

The cluster definition given above characterising clustering firms and their supporting institutions as geographically concentrated indeed begs the question whether clusters can truly be an international phenomenon. Despite the ability to organise decentralised production processes and to stay in touch via modern means of communication, face-to-face contact remains very important to circulate the 'tacit knowledge and know-how' upon which hinges the success of a cluster.

Rosenfeld (2002) emphasises not only the role of transport systems, but also cultural identity, personal preferences and social factors deciding how far apart members of a cluster can be located. However, while proximity is needed to spread knowledge, clusters also depend on fruitful relations with the outside world (be it with the next urban centre or with a company located in another country) to bring in new stimulus and ideas. Another related problem of international clusters would be the absence of a readily available common pool of specialised labour.

As shown above, SME and cluster internationalisation faces many tangible and intangible obstacles. In the following, measures to strengthen SMEs to overcome these hurdles, such as technical and financial support, as well as the cluster strategy will be presented.

Measures to Strengthen SMEs in an International Environment

As has been noted above, SME face an uphill battle wanting to go international. However, many policies are already in place to support SMEs in their international endeavours targeting above all the technical aspects of SME internationalisation.

In order to help prepare SME accession to foreign markets, public authorities have recognised the importance to foster the modernisation of production equipment and technology transfer to improve their competitiveness and productivity at the international level. A number of schemes providing financial aids are offered to SMEs in this respect.

In addition, public policy measures to support SME internationalisation offer special tools addressing the financial aspect of SME internationalisation such as providing insurance against political, environmental and commercial risk. An example would be the Italian Law of May 24th 1977, No 227, known in Italy as 'Ossola Law' setting up a special insurance fund for SMEs operating abroad. Another policy measure is to support export consortia, to make available special funds to finance SME presence in international markets, or to favour access to credit on favourable conditions for international SME activities. The network of national chambers of commerce abroad is supposed to alleviate the problem of information in foreign markets. However, there is an awareness of the need to improve the quality and quantity of services to SMEs in general, such as specialised counselling and training courses preparing entrepreneurs for internationalisation.

Public policy measures already in place to support SME internationalisation should be adapted to suit the needs of clusters wanting to go international. In the following section, it will be explained how the cluster strategy can assist SMEs when tackling the international environment.

SME Internationalisation - The Cluster Strategy

As described above, firms wanting to go international face informal trade barriers such as weak contract enforcement and lack of information about business opportunities. Recent research has shown that most international trade is in fact based on transnational business and social networks alleviating these seemingly insurmountable obstacles (Rauch 2001). This is not surprising as some authors postulate that '[national] markets are more or less stable networks of business relationships.' In this respect, international networks act as intermediaries who watch over the enforcement of business deals and who connect newcomers with domestic players by spreading information about business opportunities. In addition, transnational production networks play an important role in facilitating technology transfer. The importance of these networks, mostly based on socio-cultural ties, cannot be underestimated.

SMEs and clusters should emulate the strategies used by international trade networks in order to succeed on the international arena. To begin with, a conscious effort should be made to strengthen inter-firm relationships to develop a common identity capable of working beyond national boundaries. The existence of a national diaspora in a third country can be used as a stepping stone for SME clusters facilitating the penetration of a foreign market. Compatriots can identify opportunities for trade and investment, and advise on the intricacies of a foreign regulatory, political and cultural environment. A first successful operation having been launched, an international cluster can form around lead firms, which have already penetrated a market.

But international clusters do not necessarily need to be based on common ethnic ties in order to be successful. In most cases, the definition of a credible common interest is sufficient to forge and sustain working partnerships. For example, pilot projects supported by the EU, such as the twinning of the nascent organic food production in Poland with the agro-food sector of southern Italy, a major player in the production of organic food, can bring together actors to engage in learning and help open up new markets or market niches (Financial Times, 14 October 2002). It should be noted, however, that continuous energy and efforts need to be invested to overcome potential misunderstandings and faulty communication having its roots in cultural and linguistic differences.

Another possibility to facilitate the birth of international clusters would be to invest in the formation of virtual clusters. A virtual cluster is a network of clustering firms grouping together various entities from different countries or regions targeting similar markets or sharing the same technological challenges. A virtual cluster helps for example to exchange information among participants, to stimulate innovation and to foster the development of new technologies through partnerships among interested parties. Via virtual clusters, international clusters can come into existence through identification of specific common markets and market niches. Collaboration can be established even if actors are separated by great geographic distances by means of electronic communication backed up by face-to-face contact.

If companies operating in a cluster are far apart from each other, special strategies need to be developed to stimulate the flow of information and the development of a common identity. International firms, especially in the branches of consulting and financial services, have been able to develop an international pool of specialised labour with a common culture. The means was to actively create and disseminate a corporate identity. An international cluster needs to invest in the development

of a corporate identity, for example by fostering exchanges of personnel among participating firms and by organising common training courses.

CHALLENGES AND PROSPECTS OF CLUSTER INTERNATIONALISATION

After having outlined above the cluster strategy to overcome obstacles to SME internationalisation, the next part of the paper will address the challenges and prospects of cluster internationalisation for firms in OECD and non-OECD countries.

Challenges of Cluster Internationalisation

The development of sustained co-operation between SMEs in transition and developing countries and SMEs in industrialised countries can be of major importance both for the development of SMEs in these respective regions and for economic and social progress world-wide. While globalisation is certainly driving the process of SME and cluster internationalisation, it is important to assess both the advantages and disadvantages of this process. In the following paragraphs, challenges of cluster internationalisation will be outlined both for transition and for OECD countries.

Challenges for SMEs and Clusters in Transition Economies

For their part, SMEs and clusters in transition economies can respond to the process of internationalisation in two ways, either adopting a reactive or a proactive strategy. Until now, the reactive strategy seems to be prevailing: In most cases, local firms react to the presence of foreign business interests in their country by trying to integrate their businesses into a vertical production chain. The impetus is thus coming from a foreign investor outsourcing parts of its production process to a third country - As a response, local SMEs attempt to fulfil production requirements or search for niches around a main business operation or its spin-offs. Transition economies, especially in central and eastern Europe, are an attractive destination for foreign direct investment due to the presence of skilled labour and cheap labour costs. An example would be the automotive sector, where big international firms have opened production plants in central Europe over the last decade. The inherent danger for SMEs and clusters in these countries is to become trapped in the lower part of the value-chain risking the loss of skills of its industrial base.

But reacting to internationalisation is not the only possibility: Increasingly, SMEs and clusters from transition economies attempt to adopt a more proactive approach by trying to export their products and services. As described in an earlier section, these firms face many obstacles as it takes an enormous effort to break into the international market. These difficulties are aggravated by conditions specific to transition economies. Among the main pitfalls are: Lack of experience with international operations, weak cohesion among cluster companies, a shortage of capital to be invested in international endeavours and the absence of special public support programmes.

Challenges for SMEs and Clusters in OECD Economies

What are the challenges of internationalisation for SMEs and clusters in OECD countries? In many respects, their situation represents a mirror image of their colleagues' in transition economies. As part of international value-added chains, they are faced with the question of how not to lose their innovative capabilities and skills in the process. A recent study of the Italian Industrial District of

Brenta (Rabellotti 2001) has shown that its integration into the international production of luxury leather goods was in fact having negative consequences on the requisite variety of skills available among companies of the district. In addition, social cohesion among cluster firms in the district showed signs of decline.

In turn, clusters wanting to operate in transition economies face red tape and an intransparent regulatory environment favouring insiders. Often, differences in business culture present a major obstacle to the establishment of good working relations.

After outlining the potential pitfalls of SME cluster internationalisation for transition and OECD countries, prospects of cluster internationalisation will be presented.

Prospects of Cluster Internationalisation

Foreign direct investment by SMEs or bigger firms plays a crucial role in the internationalisation process. Within the right framework conditions, foreign direct investment (FDI) can have beneficial effects on the region of destination both in terms of job creation and investment in infrastructure. Criteria for success are the existence of strong local business systems of inter-linked enterprises and effective support services by the private as well as the public sector in the target area.

Prospects for SMEs and Clusters in Transition Economies

Successful clusters often incorporate a lead firm active on the international level which can tap into the knowledge of an international network and possesses access to internationally trained staff and research opportunities. For SMEs and clusters in transition and developing countries, to become part of an international cluster grouped around a leading player from abroad potentially opens the door to many opportunities, such as learning new skills and upgrading its technology.

But transition economies do not only figure in the picture of SME and cluster internationalisation as mere recipients of FDI and target markets of foreign companies. More often, these countries have already identified internationalisation as a strategy for themselves. For SMEs and clusters in transition economies, the strive to go international promises access to new markets, the possibility to occupy a market niche and to increase their competitiveness by honing their skills in competition with international players. But international markets need not be far away: Business opportunities in the form of old commercial ties among the countries of central and Eastern Europe and the former Soviet Union should not be underestimated and be explored further.

Prospects for SMEs and Clusters in OECD Economies

For SMEs and clusters in OECD countries, becoming part of an international production chain promises access to higher profit margins and bigger markets. It appears for example that the Italian luxury goods industry as a whole is currently moving into the high-profit segment of the market, utilising its cross-sector core competencies in design, branding and marketing with great skill. Companies participating in the luxury value chain have seen both their profit and their performance increase in the process (Rabellotti 2001).

As for SMEs from OECD countries wanting to go international, the decision to operate in transition economies often is a question of survival: The outsourcing of parts of a production process becomes a

vital measure for cutting the punitively high cost of labour in their country of origin (Velo 1999). In other cases, it is the shortage of labour in industrial districts and clusters that drives SME entrepreneurs abroad in search of a resource that is scarce at home due to the saturation of the labour market.

After having outlined prospects for SME and cluster internationalisation, this discussion paper concludes with possible avenues for future co-operation.

EAST WEST POTENTIAL - EAST EAST POTENTIAL OF SME CLUSTER INTERNATIONALISATION

Globalisation, and the associated process of SME and cluster internationalisation is here to stay. As problems arising from this phenomenon cannot be solved by individual actors alone, clusters from around the world stand to benefit from international cluster co-operation. The East West Cluster Conference wants to encourage the exchange of information crucial to overcome drawbacks SMEs face in the internationalisation process. In this respect, concrete possibilities of partnership among clusters world-wide need to be explored. The creation of an International Cluster Club as motor and learning area for SME internationalisation could release the potential of international cluster co-operation, be it among East West or East East counterparts.

To foster cluster internationalisation, private sector initiatives alone will not be sufficient: Public authorities are called upon to design and implement suitable policy responses and to review the SME policy framework already in place in the light of the ongoing process of globalisation affecting SMEs around the world.

QUESTIONS FOR DEBATE

1. What are the main barriers to SME internationalisation ?
2. How can clusters help respond?
3. Can and should clusters shield themselves from the process of internationalisation?
4. For what kind of clusters is internationalisation a suitable strategy?
5. What are the barriers to SME exports and possible policy solutions? Can clusters help?
6. What strategies could help SMEs/ SME clusters to compete internationally?
7. What organisations help to bring about and sustain the identity of an international cluster?
8. How can the existing policy framework be adapted to suit the needs of international clusters?

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