

Global Agenda

What Companies Want from the World Trading System

September 2015



Uri Dadush
Beatriz Leycegui Gardoqui
Christopher Logan
Alex Manson
Susan Schwab
Vera Thorstensen

© WORLD ECONOMIC FORUM, 2015 – All rights reserved.

No part of this publication may be reproduced or transmitted in any form or by any means, including photocopying and recording, or by any information storage and retrieval system.

REF 021015

Contents

- 3 Preface
- 4 Introduction
- 6 The View from Multinationals
- 8 SMEs in International Trade: The View from Developing Countries
- 11 SMEs in International Trade: The Special Case of the United States
- 12 The Rise of Services and the Role of SMEs
- 14 The Role of Private Standards
- 16 The Role of Trade Finance: The View from the Banking Industry
- 17 Conclusion
- 18 Endnotes
- 18 References

Preface

The world needs trade and investment to drive growth and development. Trade and investment activity, in turn, results from a great quantity of individual commercial decisions taken by business large and small around the world.

Understanding these dynamics is the business of the World Economic Forum's Trade & Investment initiative. This means going beyond narrow definitions of trade to explore the exchange of ideas, ways of working and the many determinants of trade and investment choices; it means going beyond the confines of policy to reckon with new technology and business models.

This second report of the 2014-2016 Global Agenda Council on Trade and Foreign Direct Investment delves into what companies find most valuable in the world trading system, what they struggle with and what they seek.

Emerging from the council's thoughts we see a keen interest in democratization and transparency in trade and investment arrangements. This applies particularly to smaller businesses and those engaged in services – both key suppliers to even the largest enterprises. Effective and inclusive standards and financing arrangements are highlighted as important supporting elements.

The council's thoughts on these topics provide perspective with which to view the more detailed policy options beginning to flow from the E15 Initiative. They illustrate both the need and the possibility for change.

The Forum would like to thank all the members of the Global Agenda Council on Trade & Foreign Direct Investment and, in particular, Jonathan Fried, Chair, Ambassador and Permanent Representative of Canada to the World Trade Organization; and Peter Draper, Vice-Chair and Senior Research Fellow, Economic Diplomacy Programme, South African Institute of International Affairs, South Africa.

Sean Doherty
Head, International Trade and Investment
World Economic Forum

Introduction

The post-war world has seen remarkable advances in prosperity and poverty reduction. Associated with these advances has been an unprecedented expansion of international trade and investment. Whereas international trade was 25% of world GDP in 1960, it exceeds 60% today (World Bank, 2015). This progression owes much to technological advances as well as to consumers' demand for greater variety and quality as their incomes increase, although trade and investment liberalization policies have been instrumental. In particular the system of norms, laws and regulations established multilaterally under the General Agreement on Tariffs and Trade/World Trade Organization, extended and deepened by bilateral and regional trade and investment agreements such as the European Economic Community, North American Free Trade Agreement (NAFTA), hundreds of free trade agreements (FTA) and over 2,000 bilateral investment treaties, has created an environment where trade in most parts of the world and in most sectors is largely open and predictable. For example, according to a recent paper by World Trade Organization (WTO) and Organisation for Economic Co-operation and Development (OECD) economists, 80% of developing countries' exports by volume now regularly enter advanced countries duty free, compared to 55% 20 years ago (WTO, 2014).

Against this background, private enterprise, measured for example by the number of firms active in international trade or by their stock market capitalization, has flourished as never before. However, with rapid advances in communications and transport technologies and the globalization of production marked by the proliferation of complex global supply chains, the demands on the trading system for deeper and more comprehensive disciplines have increased greatly. Meanwhile, the Doha trade-negotiation round has been written off in various quarters, many bilateral and regional deals are struggling to conclude, spontaneous liberalization has slowed and is being reversed in some countries, and world trade has decelerated sharply in the wake of the global financial crisis. Not surprisingly, there is now pervasive concern (some would say alarm) that the trading system is no longer delivering that which private enterprise needs. The central point is that trade rules and reforms of behind-the-border regulations that have a profound impact on trade are evolving far too slowly – they are not even remotely keeping pace with the hectic speed of change faced by international enterprise.

For reasons of efficiency and equity, the consequences of this troubling situation for smaller enterprises are of special concern. While the rise of the internet and of express delivery package services has created the potential for a multitude of small companies to sell and buy all over the world, thereby taking the efficiency-enhancing effect of trade potentially to a new level, their involvement in trade remains limited in most instances, and international trade continues to be dominated primarily by the largest corporations. According to the Financial Times (FT), at present almost half of the revenues of companies that are part of the S&P 500 are generated internationally, compared to a little shy of a quarter for “small-caps”, which, despite their appellation, are actually large companies, with market capitalization of \$300 million to \$2 billion. International trade is more open and predictable than ever before, but the cost and complexity of engaging in international trade remain far too high and often prohibitively so for small companies. Researchers have estimated that “trade costs”, the total cost incurred in delivering a product from the factory door to the ultimate consumer, including transport, customs procedures and distribution, can easily exceed the cost of its production, and that these “trade costs” could be substantially reduced if customs procedures and transport regulations were rationalized, distribution channels were made more competitive, and protectionist standard setting and corruption were reduced.

This report aims to set out some important ways in which the world trading system, beginning with the WTO which is at its centre, can better serve the needs of the 21st century private enterprise. Addressing these concerns would not only be beneficial for productivity and living standards across the world, but also would encourage private enterprises, especially smaller firms, to become more active participants and advocates for trade.

As Susan Schwab shows in the next section, multinational companies are increasingly hailing from developing countries, and they have much in common with established players from advanced countries. She explains why all these large enterprises have lost interest in the WTO, and what they want from multilateral trade negotiations to become re-engaged. The specific needs of small and medium-sized enterprises (SMEs) are then examined by Beatriz Leycegui from a developing country perspective, and by Christopher Logan from the US perspective. They show that, despite big differences in productivity and living standards, the

impediments constraining small enterprises across the world from adequately participating in trade are similar; in a nutshell, all these impediments have to do with the cost and complexity of engaging in international trade and the limited resources to overcome them.

The cross-cutting contributions of these authors are followed by an examination of more specific concerns. Uri Dadush shows that the structure of world production and of international trade is shifting rapidly from manufacturing to services, where SMEs are most active, and that the foreign currency earnings of developing countries have become more diversified. He argues in favour of policies that promote increased connectivity with the world across the board, favouring all companies, rather than assistance to specific sectors and the politically powerful. Vera Thorstensen takes a sceptical view of the proliferation of private standards, which carry some benefits (as many are market-driven) but also the risk of distortions, arbitrariness and new impediments to trade. Finally, Alex Manson argues that there are unintended adverse consequences from the higher prudential and conduct regulation of banks in the wake of the financial crisis. He highlights in particular the increased cost of trade finance and the heightened risk of financial exclusion, and advocates that they be addressed through collaboration between policy-makers and the banking sector.

A number of broad policy recommendations stem from these analyses and are found in the individual contributions to this chapter. Not included here for the sake of brevity and accessibility to the general reader are detailed and specific recommendations. These can be found in background papers available from the authors.



The View from Multinationals

Multinational corporations face the judgement of the marketplace every day. Since the Doha Round multilateral negotiations first ran aground in 2003 in Cancun, US-listed public companies have provided quarterly financial statements, and explained them to analysts about 50 times. Even though many of these firms are heavily dependent on world trade, it should not be a surprise that what goes on at the WTO in Geneva has not been a burning priority for them. Answerable to shareholders and their many other stakeholders for results, they have had to navigate extreme volatility in financial and commodity markets, geopolitical upheavals and dramatic swings in government intervention in their markets, with little of relevance emanating from Geneva for some time. Instead, they have primarily engaged with governments on bilateral and regional deals being negotiated outside the WTO, where real movement is more likely.

What results are these multinational enterprises looking for from trade negotiations? The vast majority of these firms are looking for an open and predictable trading environment, and, moreover, there is little difference in view between multinational enterprises (MNEs) originating in developing countries and those from advanced countries. However, multilateral processes are simply not delivering what these firms want.

First, a definition: what is a multinational enterprise? According to the FT's lexicon, "global multinational enterprises" are companies engaged on a truly international – rather than just regional – basis. To fit the FT definition, a MNE must have "at least 20% of its sales in each of at least three different continental markets....[whereas] a company where 70% of their sales are generated in Asia would not be considered a global MNE even though they might have significant operations in more than one country...". Note that under this definition, even a relatively small firm, with access to the internet and express package delivery service can be a MNE!

A more widely accepted definition, also somewhat loose, is any company that has operations – through production and/or provision of services – in more than one country. More precision is found in the Fortune Global 500, where firms are ranked by annual revenue as reported to a government agency, regardless of the nature of their business. Obviously, not all of these are MNEs by the FT definition, and there are many more than 500 MNEs in the world, but looking at Fortune's list, they hail from 36 economies and employ 65 million people worldwide (roughly 2% of the world's working population).

According to McKinsey Global Institute (2013), whereas in the 2010 Fortune rankings only 17% (85) of the companies came from emerging markets, by 2025 they project the emerging market share will be 46%, with slightly over half of that from "Greater China," a combination of China, Hong Kong SAR, Taiwan and Macau – with the Chinese firms most likely to qualify for the Fortune list without also qualifying as multinationals.

The same McKinsey study also suggests that at least a quarter of firms that currently derive annual revenues of over \$1 billion are in emerging economies, and that by 2025 (when close to 15,000 such firms will exist), close to half will come from emerging markets. These statistics call into question the widespread perception that MNE interests in trade negotiations are exclusively the province of negotiators from advanced countries.

At the risk of generalization, it turns out that these MNEs want pretty much the same things from trade negotiations, whether they originate in advanced or developing countries, and whether they are very large or very small – even if the detailed provisions will vary greatly by sector, size and country of origin. The things all MNEs are looking for are market access, rule of law and a stable environment in which to do business. In addition, MNEs will be vitally interested in the business environment – regulation related to trade in goods and services (including data flows) and investment – because they are often engaged in business ventures that involve multiple forms and levels of activity.

If they are interested in creating, researching, developing, producing or selling products or services containing proprietary knowledge (which is almost always the case), they will be interested in intellectual property protection. Some of the larger MNEs – those that only expect to benefit indirectly from trade agreements through increased trade flows – such as shippers, hospitality and travel firms – may or may not seek direct benefits from the agreements themselves but will be very supportive of them. Generally, these firms are also impacted by rules governing services, investment and intellectual property.

MNEs vitally require the ability to source and sell in multiple markets and, with the lengthening and regionalization of production value chains, want the flexibility to adjust what and where they produce to meet the changing needs of their customer and the competitive marketplace. As major purchasers of inputs – some from small businesses purchased locally; some imported, either in the form of captive imports or sourced from others – a MNE's interest in market access and the reduction or elimination of barriers

to entry applies to all markets. For example, analysts at The Heritage Foundation recently estimated that approximately half of all intermediate inputs used in the United States are imported (Olson and Kim, 2015).

In many instances, though by no means in all, MNEs are in favour of improved access to their home market as well as to markets abroad. Similarly, these MNEs also source extensively from export-oriented small businesses. Given the strong connections that exist between large and small businesses, the distinction between the interests of the two groups can be overdrawn. For example, the Business Roundtable issued a survey in late 2010 that found the “US-parent operations of the typical US multinational buys goods and services from more than 6000 American small businesses; buys a total of more than \$3 billion in inputs from these small-business suppliers; and relies on these small-business suppliers for more than 24% of its total input purchases...” (Business Roundtable, 2010).

In addition to the core benefits of trade agreements related to market access, investment and R&D, MNEs are increasingly realizing that other benefits might be derived from them. A good example relates to the potential anti-corruption implications of certain trade measures: given the extra-territorial reach of the Foreign Corrupt Practices Act and the UK Anti-Bribery law, multinationals are very wary of the advantage afforded to firms that are less constrained. So they particularly welcome trade agreements that enhance transparency and disclosure rules and trade facilitation, streamline customs clearance procedures, or establish more open competition for government procurement. These agreements can both enhance market access and level the playing field by reducing the opportunities for corruption.

Ultimately, all firms of any size are looking to grow revenues and contain costs, and trade-liberalizing agreements enable both. Indeed, the statistic used most frequently by business lobbyists and politicians during trade debates is that over 95% of the world’s consumers live outside the borders of the United States. No matter where a MNE is domiciled, its potential market is very likely to be greater outside than inside the border.

This short list of key trade priorities for MNEs can, in principle, be negotiated multilaterally: market access for goods and services; access for foreign direct investment; rule of law, due process, transparency and other elements of a stable business environment; protection of intellectual property; measures that contribute to anti-corruption outcomes; etc. In fact, for a multinational, meaningful WTO agreements that address some or all of these issues could

ultimately be far more useful than a patchwork of bilateral or regional agreements.

The problem is that since the conclusion of the Uruguay Round in 1993, with very few exceptions such as the Trade Facilitation Agreement, the expansion of the Information Technology Agreement and negotiations over Trade in Services and Environmental Goods, the only trade agreements that have delivered results have been bilateral and regional ones. Unfortunately, for MNEs, like SMEs, farmers and other stakeholders – the second or third best option is the best option available.

SMEs in International Trade: The View from Developing Countries

Small and medium-sized enterprises (SMEs) account for 95% of enterprises around the world and provide 60-70% of private-sector employment (ITC and WTO, 2014) but they only represent one-third of the world's GDP. Their relatively low productivity is associated with a high degree of informality and relatively low participation in world trade.

A uniform definition of SMEs does not exist. Table 1 illustrates how definitions vary across international organizations (ITC and WTO, 2014). Nonetheless, approximately one-third of SMEs in Latin America and the Caribbean are single product, single market exporters and half of them that set out to export exit the market within

a year, with slightly higher figures for the rest of the world (IDB, 2014). Although they confront common challenges, there is no “one-size-fits-all” approach that can solve their difficulties. Different solutions must be designed accordingly. Government intervention is necessary through adequate industrial policies that correct market failures affecting them. According to the IDB (2014), it is important that governments “embrace a holistic and coordinated set of national economic and trade policies along with requisite managerial and operational practices within SMEs and targeted institutional innovations”. Of equivalent relevance is to use effective metrics or results measurement mechanisms.

Table 1: Criteria Used by Listed Institutions for Defining SME

Institutions	Maximum no. of employees	Maximum revenue or turnover (US\$)	Maximum assets (US\$)
World Bank	300	15,000,000	15,000,000
Inter-American Development Bank	100	3,000,000	None
African Development Bank	50	None	None
Asian Development Bank	50	None	None

Source: Gibson, 2008.

The contribution of SMEs to total exports in value in Latin America and the European Union is just above 13% and 25% respectively (IDB, 2014; European Commission, 2014). In Asia, where they have been more successful in trade, they represent 30% of this region's exports; China and India stand out, as SMEs contributed 60% and 40%, respectively, to these countries' total exports from 1998 to 2008 (ADB, 2015). Table 2 provides additional information about some of the larger economies in each region (ITC and WTO, 2014) and illustrates the relatively small participation of SMEs in exports. Galvanizing SMEs to raise productivity and participate more actively in world trade would help accelerate economic growth, reduce unemployment and also improve income distribution, since many owners of SMEs and those employed by them are relatively poor.



Table 2: The Importance of SMEs for Trade and Economic Activity

Country	Share of firms (%)	Share of employment (%)	GDP value added (%)	Share of SMEs exporting (%)
Brazil	99.9	77	61	11 (S)
Canada	99.7	60	25*	10*
Chile	98.9	80	25	15
China	99.0	73	60	40-60 (M)
Colombia	96.4	84	-	20
EU	99.8	70	61	25°
India	95.0	80	40	32 (M)
Japan	99.0	72	52	14 (M)
Mexico	99.8	74	52	-
New Zealand	99.8	75	-	-
Sweden	96.3	60	57	24 (M)
Taiwan, China	96.3	80	-	56 (M)
US	99.9	50	50	31 (M)

Note: SME share of firms, employment and GDP. Fraction of SMEs engaged in export activities. (M) and (S) denote data for manufacturing and services data only.

Source: OECD (2014), except those marked with an (*) taken from Government of Canada (2013), and (°) taken from European Commission (2014).



The limited success of SMEs on world markets and their fear of competition emanating from large multinational firms in their domestic markets help explain why SMEs have not been particularly enthusiastic about opening their economy through the negotiation of trade agreements, and even less so through unilateral measures. Yet, the substantial transformation in the 21st century of a world of trade in final goods to one where trade in inputs plays a crucial role provides new opportunities for SMEs across the world to become incorporated in global value chains. The increased importance of services, in which SMEs are prevalent, and the seamless integration of services and manufacturing across borders also creates new opportunities (see the section below on services).

SMEs that become global tend to employ more workers, pay better wages and achieve higher sales and labour productivity (IDB, 2014). Their increased participation in trade can result in higher and more inclusive economic growth. In developing countries the growth of SMEs can be associated with increased employment, poverty reduction, women's economic empowerment and less skewed income distribution (ITC and WTO, 2014).

Governments must build on this knowledge in articulating domestic policies and in structuring FTA, taking a cue, for example, from the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) negotiations, which incorporate chapters dedicated to SMEs. Among the most important provisions are those designed to improve information flow, promote training, facilitate participation in government procurement, and meet technical standards and regulations (see the box).

SME Challenges and Policy Options to Address Market Failures

Financing

Financing is ranked in diverse surveys as the most important limitation. Given the mortality rate of SMEs, which is five times higher than large firms, and with a practically non-existent financial track record, they are forced to rely on their own sources (ADB, 2015). Close to 55-65% of formal SMEs in developing economies are either unserved or underserved in terms of their access to financing (International Finance Corporation in ITC and WTO, 2014).

Policy options

SME loan guarantee programmes - Governments could provide a counter-guarantee to private financial institutions that lend to SMEs, reducing their losses caused by default. Experience shows that the guarantee can be as high as 90% of the credit, while the lender assumes only 10% of the risks.

Credit risk databases - Given the absence of an integrated database across emerging markets, government(s) could work with the financial sector to aggregate information and make it available to participants by way of a common utility of uniform high standards. Long-term scoring databases for SMEs that measure their risk of default and rates of return would lower the reluctance of financial institutions to consider lending to SMEs.

Information constraints

SMEs most frequently lack market intelligence, including on potential markets, the nature of demand, likely clients, competitors and their products' competitive position, the regulatory framework, logistic alternatives, the availability of private and public financial sources and support programmes, innovative technology and preferential treatment under FTAs, among other elements.

Policy options

Integration in global value chains - Governments and MNEs could create mechanisms to help SMEs identify the latter's demand for goods and services, as well as their time, quality and volume requirements.

SME support centres - Partially or totally sponsored by governments to guide enterprises in accordance with their level of sophistication and knowledge, training them in management, innovative processes, strategic planning, marketing, accounting and the use of technology, among others, such centres could be created or enhanced.

SME online platforms - Governments alone or with the private sector could develop hubs that provide business links, ratings and reviews of possible clients, suppliers and investors, and the possibility to buy or sell products online; inform on trade finance opportunities; offer trade and facilitation infrastructure (tariffs, preferential treatment, technical regulations, customs procedures) as well as technical assistance, among other relevant services.

SME demand and supply collaborative networks - Governments could promote schemes in which SMEs collaborate more closely in buying and selling their products; purchase jointly raw materials, machines, equipment and services; and market and sell their products. Through this collaboration they increase their bargaining power with suppliers and customers.

As SMEs increase their participation in trade and attract overseas investment, their resistance to trade and investment liberalization is likely to moderate. SME forums comprising government and private-sector representatives can help further this policy agenda across a broad front.

However, trade opening must be accompanied by domestic policies that address weaknesses in the business environment that especially penalize SMEs. In many instances this will require a tailored set of interventions designed to remove the most egregious market failures and infrastructure bottlenecks confronting different SME sectors. Clearly, SMEs that improve their productivity and consolidate their position domestically are more likely to compete effectively on world markets.

SMEs in International Trade: The Special Case of the United States

Americans tend to think about trade as being in the realm of large business, and multinationals do, in fact, account for the bulk of exports. However, SMEs play a large and rapidly growing role in trade and benefit from it greatly. In the United States in 2013, SMEs accounted for approximately 35% of total goods' export value, up steadily from 26% in 2002. Moreover, from 2010 to 2013, the percentage of small business respondents who were exporting grew by 12% and the percentage who wanted to export increased by 20% (NSBA, 2014). The IT revolution and the spread of convenient package services have reinforced this trend.

Free trade agreements help open up and potentially simplify trade in ways very beneficial to small businesses but, even in the United States, a relatively sophisticated economy with large numbers of highly productive and profitable SMEs, small businesses need quite a bit of help to navigate internationally. Companies of all sizes face import tariffs, which vary greatly by country of destination and the commodities traded. However, non-tariff barriers, such as cumbersome customs procedures and a host of country-specific regulations, matter more and SMEs face proportionally greater impact from these non-tariff barriers. In practice, overcoming these barriers often requires significant financial and technical resources, not readily available in small companies, and results in a reluctance to prioritize export markets or even to engage at all.

For example, a 2014 report by the US International Trade Commission investigating barriers faced by US SMEs exporting to the EU found that differences in standards and regulations placed a greater relative burden on smaller companies than larger ones. In addition, there were perceived challenges regarding retaining trade secrets and intellectual property more broadly, high patenting costs, inefficient and costly logistics, and cumbersome customs procedures, particularly relating to appropriate product classifications, and the levying of value-added taxes (USITC, 2014).

But even in North America, trading under the NAFTA umbrella is far from straightforward for SMEs. Thus, to take advantage of NAFTA preferences, detailed rules of origin requirements must often be met. Obtaining the required documentation can be very burdensome for smaller businesses, especially if components and raw materials originate from multiple trading partners. Complex rules of origin apply to garments, textiles and a number of sophisticated products, such as regional value content requirements (calculated either by transaction value method or net cost method). Many small businesses opt to pay the full tariff instead. One driver of preference utilization rates

is the amount of tariff due: for example, in trade between Canada and the EU, utilization rates tend to go above 50% only when duties reach the range of \$1,000-10,000.

Among SMEs that are not currently exporters, surveys suggest that the largest barrier is that they just don't know how to get started. Consequently, the most frequently requested type of support is training and technical assistance, reflecting in particular strong concerns about the regulatory requirements, complexity and time required to become an exporter.

As mentioned, e-commerce has had a strong positive impact on many small businesses, both by opening up new export avenues and facilitating access to low-cost imported inputs. Marketplaces such as eBay and Alibaba have made selling and sourcing internationally much easier by reducing many non-tariff barriers to trade, most importantly information. In addition, integrated express companies such as DHL, UPS and FedEx have provided a logistics backbone for these transactions. However, to date the majority of these advances have been a boon only for smaller and infrequent shipments. SMEs seeking to import or export in volume must still find their own way through the trade maze or incur additional costs in paying for brokers or other middlemen to assist.

It is good news for SMEs that the more recent FTAs and many that are in negotiation, such as the TPP and TTIP, are focusing more closely on non-tariff barriers than ever before. The Bali Agreement on trade facilitation, ratified by 16 countries as to 15 September 2015, would be a great help when implemented after two-thirds of the WTO Members ratify it. However, even with a strong focus on reducing non-tariff barriers, the need for simplicity remains. Even if new FTAs make it possible for traders to pay less tariff duties and avoid regulatory and other impediments, the reality is that SMEs will only benefit if they know how to take advantage of these provisions and it is cost-effective for them to do so.

The Rise of Services and the Role of SMEs

Manufacturing is declining as a share of GDP, not only in advanced but also in developing countries while, conversely, services are rising in importance earlier in the development process. Although, measured on a gross basis, the exports of services are smaller than trade in manufactures and their share in total exports has changed little in past decades, new trade statistics based on domestic value added show that the domestic value added of services exports is actually larger than the domestic value added trade of manufactured exports and that, moreover, services are rising rapidly in importance as inputs in manufactured exports (Baldwin, 2015). The relatively high level of protection in services, and the limited scope of disciplines agreed so far at the multilateral level in those sectors, means that the stakes in services negotiations being carried out in the WTO and in several regional forums are high. Introducing more international competition in the service sector can thus boost economy-wide efficiency and play an important role in promoting export growth directly and indirectly through manufacturing. Since SMEs play a disproportionately large role in the provision of services and are especially exposed to market and coordination failures, these policies would have an especially important effect on them.

The mass migration of farm hands to the textile mills of Lancashire in 18th-century England, to the steel mills of Pittsburgh in 19th-century United States, and to the smartphone assemblers of Shenzhen in today's China, are stamped in our minds as emblems of development. And indeed the manufacturing sector remains a motor of transformation in some less developed economies today. However, as has been noted in recent years by academics (for example by Rodrik, 2015), the share of manufacturing in GDP is shrinking across all countries, low-, middle- and high-income alike; the process of deindustrialization familiar in high-income countries is occurring earlier and earlier in the development process while, correspondingly, services are rising in importance sooner.

The share of manufacturing in total value added has fallen most sharply in high-income countries – from over 21% of GDP in 1990 to about 14% in 2012, on average. But it has also fallen almost as rapidly in middle-income and low-income countries (which include China), from over 20% of GDP to 16%, and even more rapidly in low-income countries, from over 14% of GDP to less than 10% (World Bank, 2014). Only a few countries have seen an increase in the share of manufacturing. Some of these countries, such



as Angola and Guinea, had a tiny manufacturing sector at the outset, less than 5% share in GDP, or countries such as the United Arab Emirates, Benin, Botswana, Bhutan, Nepal, Uganda, Saudi Arabia and Cuba, whose manufacturing share in GDP was between 5% and 10%.¹

The premature decline of manufacturing in developing countries can be attributed to a number of possible causes. These include the rise of China – which, however, is included in the developing country aggregates and so does not explain the aggregate phenomenon; the surge in commodity prices since 2000, recently largely reversed; the spread of medicines and hygiene, which has sharply increased life expectancy in developing countries and increased demand for healthcare; large investments in education; international tourism originating in advanced countries; and rising foreign direct investment in services such as finance, insurance, telecommunications, tourism, transportation, and information and communications technology, which have created whole new service sectors. Given these large shifts in technology and government policies, one should not presume that the structural transformation of today's poor countries will retrace that of their richer cousins.

Services used to be distinguished from manufacturing by the fact that they could only be consumed as they were produced; a haircut, for example, has to be done face-to-face and it cannot be stored and transported. In a seminal paper, Baumol (1967) concluded that productivity improvements in services are inherently limited since services cannot be stored, traded across boundaries or standardized. As mentioned, Baumol put forward the cost-disease hypothesis, which postulates that as wages rise, services rise as a share of GDP because they become more expensive to produce relative to manufactures which exhibit higher productivity increases. The employment share of services tends to rise for the same reason.²

But new technologies are changing this picture, and the image of the service sector as a lead ball chained to the ankle of economies – a sector incapable of technological innovation or participating in international trade – has become vastly outdated (Loungani and Mishra, 2014). Baumol's cost disease may still affect mom-and-pop restaurants and bed and breakfasts, but the modern service sector, such as telecommunications, financial and business services, now often exhibits faster productivity growth than manufacturing, is growing faster and, in some developing countries, is already larger (OECD, 2014, Chapter 4). For example, in 2011 modern services represented about one-quarter of GDP in Brazil, Russia, Indonesia and India, and 16% in China. In China and Indonesia, the manufacturing

sector is larger than modern services, but much smaller in Brazil, India and Russia.

The rising importance of services in GDP and trade, and the fact that they have recently been found to generate a larger share of value added trade than do manufactures, calls for greater attention to them in trade negotiations. At the same time, the increased interconnection of services and manufacturing, together with other trends associated with globalization, such as the opportunity to earn foreign exchange through multiple channels, including natural resources, migrant remittances, export and production licensing, and earnings from foreign investment, argue against policies that artificially promote any one sector. Such industrial policies often favour specific manufacturing or agricultural sectors, especially the politically powerful. Instead, the trends outlined above argue in favour of policies that promote opening up to the world and enhancing the business climate as well as the capacity to learn from the state of the art across all sectors of the economy, for which smaller enterprises provide the backbone. Such policies can be summarized in the four "Cs": connectivity to the world, containing cost (maintaining a realistic exchange rate, for example), enhancing infrastructure and human capacity, and maintaining confidence.

SMEs play an especially important role in the service sector and, as argued above, face a particularly daunting challenge in addressing export markets, given the large fixed costs and risks involved in exporting. Moreover, whereas large firms can at least to some degree cover these fixed costs and also reduce the transaction costs of doing business through vertical and horizontal integration – sometimes even building their own transport infrastructure – SMEs can only rely on public investment and hope for policies that reduce regulatory impediments and trade costs, and also facilitate their access to credit and knowledge of foreign markets. The strong correlation that exists between per capita income, quality of the business climate and propensity of SMEs to export (see the IDB report on SMEs, 2014) tends to confirm the view that a weak business climate is especially likely to penalize SMEs. Policies that recognize these impediments and pay special attention to SMEs are likely to enhance economic growth, increasing the probability that small enterprises become large ones.

The Role of Private Standards

International standards can promote trade in many ways, most importantly by improving product safety. Such standards can be agreed and applied by governments or by private organizations, including non-governmental organizations, trade associations and large companies, as shown in Table 3. There are many arguments for and against these so-called private standards in international trade but what is sure is that they have become a widespread reality.

Given the capacity constraints in developing countries, it is important to better understand and analyse private standards from a development perspective. It is also important to understand the implications of proliferating private standards for the capacity of the WTO to act as the ultimate arbiter on standards affecting international trade. The objective is to maximize the positive effects of private standards and to minimize the negative ones.

Table 3: Examples of Private Standards

Created by individual companies	Created by national chains	Created by international chains
Nature's Choice (TESCO)	Assured Food Standards (UK)	GlobalGAP
Filières Qualité (Carrefour)	British Retail Consortium Global Standard	International Food Standard
Field-to-Fork (Marks & Spencer)	Freedom Food (UK)	Safe Quality Food (SQF) 1000/2000
Filière Contrôlée (Auchan)	Qualität Sicherheit (QS)	Marine Stewardship Council (MSC)
P.Q.C. (Percorso Qualità Conad)	Assured Combinable Crops Scheme (UK)	Forest Stewardship Council (FSC)
Albert Heijn BV: AH Excellent	Farm Assured British Beef and Lamb	
	Sachsen Ahrenwort	
	QC Emilia Romagna	
	Stichting Streekproduction Vlaams Brabant	

Source: WTO, Sanitary and Phytosanitary Committee

At their best, private standards are market-driven efforts to ensure product safety and to establish homogeneity to reduce costs. However, private standards raise a number of concerns that in one way or another relate to the accountability and legitimacy of those who set them, as well as their potentially impeding effect on trade:

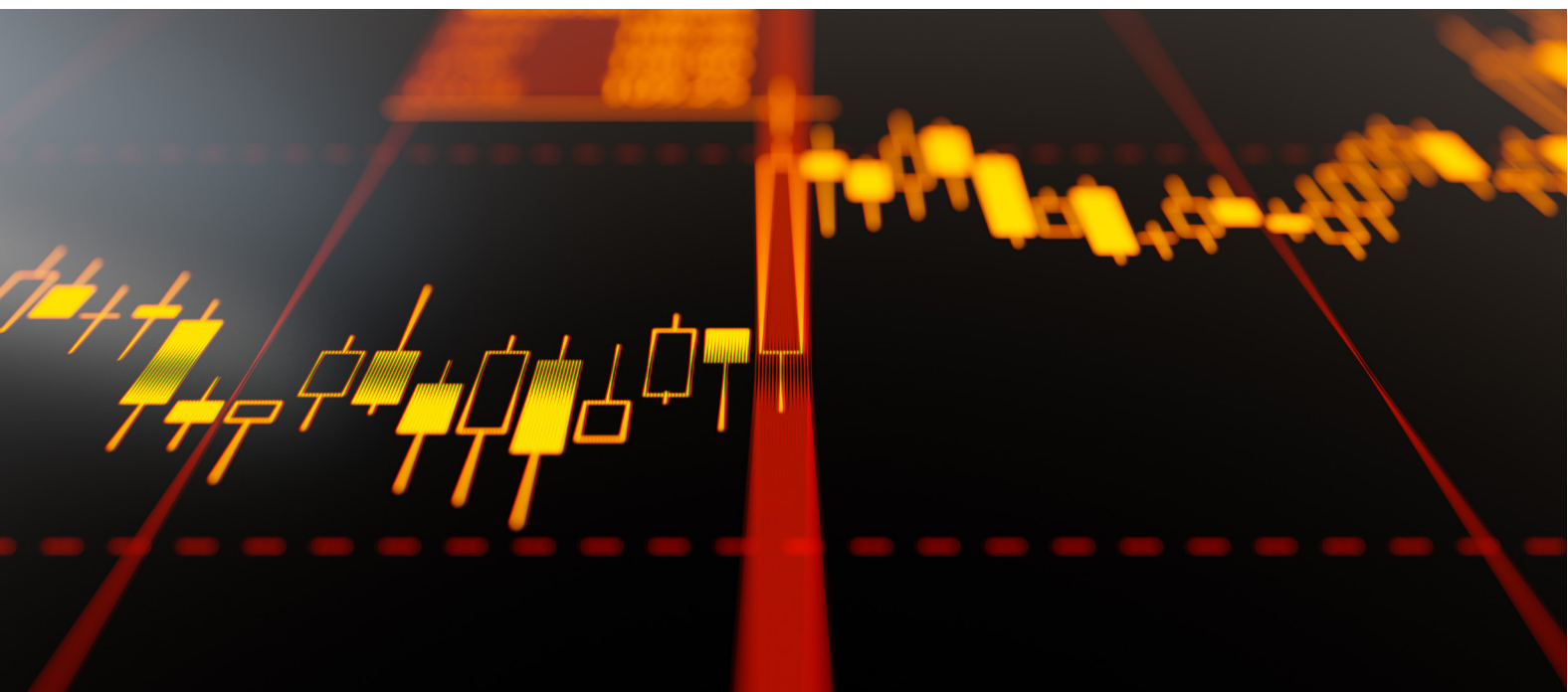
1. Lack of harmonization and equivalence on similar standards, including compliance costs, since there are multiple standards for a single product
2. Marginalization of small companies and developing and least developed countries due to complex, rigorous and multidimensional standards
3. The notion that private standards undermine the

structure of the WTO Agreements on Technical Barriers to Trade (TBT) and Sanitary and Phytosanitary Measures (SPS)

4. The risk that private standards are disguised and arbitrary measures that undermine free trade
5. The multiplication of private standards that may put at risk their sustainability objectives and create confusion for producers and consumers
6. Failure to address risks in the composition of private standards, since many of the standards are not science-based
7. The effects of many private standards that are part of global supply chains, on national policies and priorities. (UN Forum on Sustainability Standards, 2013).

To address these concerns, an international body or forum on private standards could be launched, potentially outside the WTO. It could aim to negotiate rules for these standards and also to represent the interests of their stakeholders in other international trade fora, such as the WTO. It could ensure better coordination and cooperation between consumers, industry and governments in international standard-setting forums, ranging from the International Organization for Standardization to Codex Alimentarius, to global industry or joint government-industry bodies, such as the International Electrotechnical Commission. Regulatory cooperation should be looked at as an opportunity not only to define standards but to promote common practices, resource sharing and transparency.

Given the significant impact of private standards on trade, they must also be taken up more systematically in the WTO, particularly in the SPS, TBT and Environment Committees. In the final analysis, the potential effects of private standards on international trade are a real concern and should be seen, ultimately, as a responsibility of governments and of the WTO. A number of specific recommendations have been formulated: the United Nations Forum on Sustainability Standards, for example, proposes the negotiation of a “meta-regulation” to establish some international rules for private standards and to make them work better from a development perspective. They would include, for example, the application of the “scientific principle” and wide stakeholder consultation.



The Role of Trade Finance: The View from the Banking Industry

Cross-border trade requires finance to settle import and export transactions as well as to provide access to different currency settlement systems around the world. The Bank for International Settlements (2014) estimates that banks directly supported a flow of \$6.5-8 trillion of trade finance in 2011, corresponding to a large share of the value of world trade. In 2012, bank financial institutions (BFIs) financed \$2.6 trillion via documentary trade, such as letters of credit, pre- and post-shipment loans for exporters, and \$540 billion through cross-border factoring, wherein an exporter finances itself with bank credit lines drawn against future receivables (International Chamber of Commerce, 2014a). Even when trade is not directly financed by a BFI, cross-border transactions are settled through the international correspondent banking network that links thousands of banks across the world to enable cross-border payments.

In the wake of the financial crisis, policy reform designed to improve the safety of the financial system has resulted in new prudential and conduct regulation. Changes to prudential regulation under Basel III have focused on banks' capital and liquidity requirements. While in the vast majority of cases these changes have been appropriate, some of the revisions have increased the cost to banks of providing trade finance to exporters, with the potential to constrain the availability of financing, particularly among smaller companies accessing the world trading system. Work on revised regulations between the International Chamber of Commerce (ICC), WTO, development banks and banks has addressed most of the technical issues that drive this increase in cost, although some are as yet unresolved. The calculation of prudential capital requirements on trade finance products under current Basel III implementation, for example, uses a generic corporate asset value correlation (AVC) curve as opposed to a product specific trade finance AVC curve.³ As a result of this (and other factors), the regulatory capital requirement on trade finance can be 2.5 times higher than might otherwise be the case. Yet the historical risk profile of trade finance is significantly lower than general corporate risk; according to the ICC (2014), which manages a trade registry that has tracked over 5 million trade transactions, the default rate on trade finance is only 0.033% to 0.241%, compared to approximately 1.38% for corporate bonds (ICC, 2014). An approach that reflects the relatively lower risk of trade finance would, all other things being equal, lower the cost of trade finance to exporters.

The financial industry is also changing rapidly due to the evolving standards for financial crime compliance and increased awareness by regulators and enforcement authorities of global money laundering and financial crime

activities. The cost of compliance with respect to higher standards in FCC is rebalancing the underlying economics of banking activities with the consequence that some BFIs deem providing trade finance and international payment services no longer economic. Others are increasingly selectively "de-risking" their portfolio and exiting relationships, in some cases withdrawing services entirely from markets – particularly in emerging markets – creating the potential risk of financial exclusion.

In the 2014 ICC Global Trade and Finance Survey, 39% of respondents reported closing correspondent banking accounts and 68% responded that transactions have declined due to compliance concerns. One development bank has estimated that the cost to banks of customer due diligence under the higher compliance standards exceeds \$50,000 per company. The ICC (2014) recently estimated the costs as high as \$75,000. At this level, many SMEs would be uneconomic to banks and are at risk of exclusion from cross-border finance – whether direct financing or simply completing and receiving international payments. As with existing barriers to small business in global markets, the impact of such exclusion is disproportionate for smaller businesses.

While bank financial institutions genuinely embrace the requirement to significantly increase capabilities and responsibilities to fight financial crime, the goal must be a safe financial system open to all legitimate uses. So banks also advocate a more systematic and collaborative approach to dealing with the problem, where policy-makers, banks, businesses and non-governmental organizations work together to find solutions to these issues and avoid excluding legitimate businesses and individuals from accessing the global financial infrastructure. Areas of focus could include centralized utilities to house financial crime- and compliance-related information, openly accessible to governments and market participants. Seeking such an approach as part of the process would drive alignment and standardization across regulatory bodies and geographies; the end goal could be similar in the way centralized infrastructure facilitates trading of equities across multiple markets. A system of mutual recognition of FCC standards among regulators from different countries could in the interim address the current issue of widely divergent FCC standards effectively ruling out some bilateral trading relationships at the country level, while the industry and regulators work to implement higher standards.

Conclusion

Much has been done to make trade more open and predictable over the last 70 years. However, as the contributors to this report show, the trading system still falls far short of the requirements of modern business. Multilateral negotiations are moving far too slowly to address the remaining impediments to trade and are therefore being increasingly sidelined in the eyes of executives in both large and small companies. Regional and bilateral negotiations that once had a head of steam are also struggling in many instances.

Increasingly attracted to international exchange by technological advances, SMEs are struggling to overcome the complex regulatory barriers and high costs of international trade. The service sector, which represents by far the largest sector in both advanced and developing countries, and whose share is rising, is the least well served by current multilateral disciplines. In many cases, the regulatory vacuum in both goods and services is being filled by private standard setting, which has some advantages but is no substitute for more systematic government involvement. By contrast, the increased cost of BFIs providing trade finance – the lifeblood of world trade – as a result of higher standards in prudential and conduct regulation risks lowering the availability of trade finance to exporters, even excluding them entirely, particularly in small and developing markets.

Policy-makers need to understand and respond to these pressing business concerns. Insofar as they do so, and especially as they affect SMEs, they will likely trigger a new wave of interest by global business in trade reforms, creating a powerful private and public combination that will make a real difference to future prosperity.

Endnotes

¹ Other countries that witnessed an increase in their share of manufacturing had a manufacturing share of value added greater than 10%. These countries are Belize, Dominican Republic, Honduras, Jordan, Sri Lanka, Swaziland, Bangladesh, Mozambique and Vietnam.

² On the other hand, Schettkat and Yocarini (2003) review studies that argue that the shift to services is “real”, the result of higher income elasticity of demand and not primarily a price-effect, or due to the outsourcing of service sector activities from manufacturing industries.

³ Banks’ capital requirements on trade finance exposures are currently determined using the same generic corporate version of the asset value correlation curve, which factors in expected default rates and risk correlation. Trade finance as compared to general corporate debt, however, has lower product default rates given the size of financing, and lower correlation given the underlying diversity of geography and multi-industry. A further technical detail means the relatively shorter duration (tenor) of trade finance exposures is not reflected in calculating the capital requirement on trade finance, wherein a shorter tenor should typically result in a lower capital requirement.

In addition, Basel III requires a minimum amount of stable funding depending on the type of asset held on a bank’s balance sheet calibrated to a consolidated metric known as the net stable funding ratio matching “available stable funding” and “required stable funding”. Trade assets have a required stable funding weighting factor of 50% – implying that 50% of the trade finance assets will need to be funded with 12-month maturity funds, increasing the cost of funding trade finance assets.

References

Asia-Pacific Economic Cooperation (APEC), 2007, *Best Practices – Japan: SME Support Centers*. Available at http://www.apec-smec.org/newsletter/newsletter_read.jsp?SEQ=510

Asian Development Bank Institute, 2015, *Why Do SMEs Not Borrow More from Banks? Evidence from the People’s Republic of China and Southeast Asia*, Asian Development Bank Institute, Tokyo. Available at <http://www.adb.org/publications/why-do-smes-not-borrow-more-banks-evidence-peoples-republic-china-and-southeast-asia-0>

Baldwin, R, Forslid, R and Ito, T, 2015, “Unveiling the evolving sources of value added in exports”, Draft, February. Available at <http://www.ide.go.jp/English/Publish/Download/Jrp/pdf/161.pdf>

Bank for International Settlements, 2014, *Trade finance: development and issues*. Available at <http://www.bis.org/publ/cgfs50.pdf>

Baumol, W, 1967, “Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis”, *The American Economic Review*, Vol. 57, No.3, pp. 415-426

Business Roundtable, 2010, *Mutual Benefits, Shared Growth: Small and Large Companies Working Together*. Available at <http://businessroundtable.org/resources/mutual-benefits-shared-growth-small-and-large-companies-working-together>

Credit Suisse, 2014, *Global Wealth Report 2014*, Credit Suisse Research Institute, Geneva. Available at http://economics.uwo.ca/people/davies_docs/credit-suisse-global-wealth-report-2014.pdf

Economic Commission for Latin America and the Caribbean (ECLAC), 2013, *Building SME Competitiveness in the European Union and Latin America and the Caribbean*, Economic Commission for Latin America and the Caribbean, Santiago. Available at http://repositorio.cepal.org/bitstream/handle/11362/3093/S2013022_en.pdf?sequence=1

European Commission, 2014, *Annual Report on European SMEs 2013/2014 – A Fragile and Partial Recovery*, European Commission, Available at http://ec.europa.eu/growth/smes/business-friendly-environment/performance-review/files/supporting-documents/2014/annual-report-smes-2014_en.pdf

European Commission, 2015, Small Business Act, Database of good practices. Available at <http://ec.europa.eu/growth/tools-databases/sme-best-practices/SBA/index.cfm?fuseaction=practice.list>

European Union, 2014, *Transatlantic Trade and Investment Partnership: The opportunities for small and medium-sized enterprises*, European Union. Available at http://trade.ec.europa.eu/doclib/docs/2014/march/tradoc_152266.pdf

Export-Import Bank of the United States, 2012, *Products: Supply Chain Finance Guarantee Program*. Available at <http://guides.is.uwa.edu.au/content.php?pid=43218&sid=328596>

Gibson, T and van der Vaart, H J, 2008, *Defining SMEs: A Less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries*, Brookings Global Economy and Development. Available at http://www.brookings.edu/~media/research/files/papers/2008/9/development%20gibson/09_development_gibson.pdf

Government of Canada, 2015, *SME Profile: Canadian Exporters (January 2015)*. Available at https://www.ic.gc.ca/eic/site/061.nsf/eng/h_02925.html

- Inter-American Development Bank (IDB), 2014, *Going Global: Promoting the Internationalization of Small and Mid-Size Enterprises in Latin America and the Caribbean*, Inter-American Development Bank, Washington DC. Available at <http://publications.iadb.org/bitstream/handle/11319/6412/Going%20Global.pdf?sequence=4>
- International Chamber of Commerce (ICC), 2014, *Trade Register Report*. Available at <http://www.iccwbo.org/Data/Documents/Banking/General-PDFs/ICC-Trade-Register-Report-2014-SUMMARY/>
- International Chamber of Commerce (ICC), 2014a, *Rethinking Trade & Finance: An ICC Private Sector Development Perspective*. Available at <http://www.iccwbo.org/Data/Documents/Banking/General-PDFs/ICC-Global-Trade-and-Finance-Survey-2014/>
- International Trade Centre (ITC), 2014, *50 Years of Unlocking SME Competitiveness: Lessons for the Future*, International Trade Centre, Geneva. Available at <http://www.intracen.org/publication/50-Years-of-Unlocking-SME-Competitiveness-Lessons-for-the-Future/>
- International Trade Centre (ITC) and World Trade Organization (WTO), 2014, *SME Competitiveness and Aid for Trade: Connecting Developing Country SMEs to Global Value Chains*, International Trade Centre, Geneva. Available at <http://www.intracen.org/uploadedFiles/intracen.org/Content/Publications/SME%20Competitiveness%20and%20Aid%20for%20Trade-connecting%20developing%20country%20low-res.pdf>
- Loungani, P and Mishra, S. 2014, "Not Your Father's Service Sector", *IMF Finance and Development*, Vol. 51, No.2, pp. 51-54
- McKinsey & Co. McKinsey Global Institute, 2013, *Urban world: The shifting global business landscape*. Available at http://www.mckinsey.com/insights/urbanization/urban_world_the_shifting_global_business_landscape
- Michaelides, R, Morton, SC, Michaelides, Z, Lyons, AC and Liu, W, 2013, "Collaboration networks and collaboration tools: a match for SMEs?", *International Journal of Production Research*, Vol. 51, No.7, pp. 2034-2048
- National Small Business Association (NSBA), 2014, *Small Business Exporting Survey*. Available at <http://www.nsba.biz/wp-content/uploads/2013/06/Exporting-Survey-2013.pdf>
- Olson, R and Kim, Anthony B, 2015, *Congress Should Recognize the Dynamic Benefits of Imports*, Issue Brief #4404 on Trade, The Heritage Foundation. Available at <http://www.heritage.org/research/reports/2015/05/congress-should-recognize-the-dynamic-benefits-of-imports>
- Organisation for Economic Co-operation and Development (OECD), 2008, *Removing Barriers to SME Access to International Markets: List of Government Support Programmes*, OECD Publishing, Paris. Available at <https://www.cesifo-group.de/ifoHome/facts/DICE/Business-and-Financial-Markets/Enterprise-Environment/Small-Medium-Enterprises/remov-barr-SME-List-GSPr/fileBinary/remov-barr-SME-List-GSPr.pdf>
- Organisation for Economic Co-operation and Development (OECD), 2013, *SME and Entrepreneurship Financing: The Role of Credit Guarantee Schemes and Mutual Guarantee Societies in supporting finance for small and medium-sized enterprises*, OECD Publishing, Paris. Available at [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CFE/SME\(2012\)1/FINAL&docLanguage=En](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CFE/SME(2012)1/FINAL&docLanguage=En)
- Organisation for Economic Co-operation and Development (OECD), 2014, *Small and Medium-Sized Enterprises in Global Markets: A Differential Approach for Services?*, OECD Publishing, Paris. Available at <http://www.oecd-ilibrary.org/docserver/download/5jz17jtkmzt.pdf?expires=1431530725&id=id&accname=guest&checksum=8078A2AC68F8505F6FBA869F5055FBF89>
- Organisation for Economic Co-operation and Development (OECD), 2014a, *Financing SMEs and Entrepreneurs 2014: An OECD Scoreboard*, OECD Publishing, Paris. Available at http://www.keepeek.com/Digital-Asset-Management/oecd/industry-and-services/financing-smes-and-entrepreneurs-2014_fin_sme_ent-2014-en#page4
- Piketty, T, 2014, *Capital in the Twenty-First Century*, Massachusetts: Harvard University Press
- Pötschke, K, 2014, *Big Agreements, but What's in Them for Small Businesses*, Technische Universität Dresden & Global Transaxion. Available at https://tu-dresden.de/die_tu_dresden/fakultaeten/juristische_fakultaet/jfoeffl9/globaltransaxion/conference2014/files/5-4-Poetschke-SME
- Rodrik, D, 2015, "Premature deindustrialisation in the developing world", VoxEU.org. Available at <http://www.voxeu.org/article/premature-deindustrialiation-developing-world>
- Schettkat, R and Yocarini, L, 2003, *The Shift to Services: A Review of the Literature*, IZA Discussion Paper No. 964, Institute for the Study of Labor, Bonn. Available at <http://ftp.iza.org/dp964.pdf>
- United Nations Economic Commission for Europe (UNECE), 2013, *National Strategy of Small and Medium Entrepreneurship Development: Review of the International Best Practice in SME State Support*, UN Economic Commission for Europe, Geneva. Available at <http://www.unece.org/fileadmin/DAM/ceci/icp/Review/Studies/2.pdf>
- United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP), 2015, *Analytical Framework on Credit Risks for Financing SMEs in Asia*, Asia-Pacific Development Journal, United Nations Economic and Social Commission for Asia and the Pacific (forthcoming)
- United Nations Forum on Sustainability Standards (UNFSS), 2013, *Voluntary Sustainability Standards*. Available at https://unfss.files.wordpress.com/2012/05/unfss-report-initiatives-2_draft_lores.pdf
- United States International Trade Commission (USITC), 2014, *Trade Barriers That U.S. Small and Medium-sized Enterprises Perceive as Affecting Exports to the European Union*. Available at <http://www.usitc.gov/publications/332/pub4455.pdf>
- World Bank, 2014, *Data: Manufacturing, value added (% of GDP)*. Available at <http://data.worldbank.org/indicator/NV.IND.MANF.ZS>
- World Bank, 2015, *Data: World Development Indicators, 2013*. Available at <http://data.worldbank.org/data-catalog/world-development-indicators>
- World Economic Forum, 2014, *The Global Competitiveness Report 2014-2015*, World Economic Forum, Geneva. Available at http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2014-15.pdf
- World Trade Organization (WTO), 2014, *The WTO and the Millennium Development Goals*. Available at https://www.wto.org/english/thewto_e/coher_e/mdg_e/mdg_e.pdf



COMMITTED TO
IMPROVING THE STATE
OF THE WORLD

The World Economic Forum is a comprehensive and integrated platform to strategically shape global, regional, national and industry agendas.

The Forum helps the foremost political, business and other leaders of society to improve the state of the world, serving as an independent and impartial partner and acting as the officially recognized International Institution for Public-Private Cooperation.

World Economic Forum
91–93 route de la Capite
CH-1223 Cologny/Geneva
Switzerland

Tel.: +41 (0) 22 869 1212
Fax: +41 (0) 22 786 2744

contact@weforum.org
www.weforum.org