Externally-oriented Small and Medium Enterprises: Predicament and Possibilities

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Abstract

This paper addresses emerging issues concerning externally-oriented SMEs in India and the nature of important business risks faced by them during the period of global financial crisis. The unimpressive export performance of SMEs during the period of reforms is also a reflection of the limitations of the institutional support as also weak forms of production organization. The state needs to play a proactive role in contributing to enhancing SME competitiveness. Whereas financially well protected Indian SMEs are likely to be more competitive and efficient, a greater recognition of the potential of domestic market and provision of business-facilitating infrastructure holds the key for success of SMEs across board.

Introduction

It is not for nothing that the emerging global crisis of confidence in the functioning of the well-oiled capitalistic enterprises, notoriously in the financial sector, has sent, *inter alia*, a chill through the spine of the manufacturing sector across most of the globe. Being intrinsically a manifestation of a systemic failure, infuse of some money *per se* by the state – the 'bail-out' back-ups – would achieve little in addressing the collapse in money markets that is beyond the control of it. "Some obvious consequences of the financial crisis due to the massive uncertainty that it has created are: Slowing down of investment, emergence of spare capacity in industry, economic entities going liquid, difficulty for businesses in obtaining credit for production, possibility of deep recession or depression, rise in unemployment and possibility of protectionist measures by nations to prevent their economies from declining further" (Kumar, 2009: 19).

Even the World Bank, in its latest assessment of the shape of things to come, has admitted that due to shrinkage of the world economy, not only trade would fall to its all-time low in 80 years, access to finance, especially, by the poor and developing nations would be tougher than ever (*Business Standard*, 2009: 2). That is news bad enough particularly for the externally-oriented small and medium enterprises (SMEs) in the developing countries including India; the promise of the hyped internationalization has come under scrutiny. Whereas the large enterprises have been wilting under the stress of falling demand and growing costs of maintaining physical stock as well as paying for huge wage and loan bills, which have severely dented their profitability, the SMEs, especially those appended to the large, have been desperate to survive and grow in these difficult times.

This paper presents an exploratory analysis of the emerging challenges faced by the Indian SMEs engaged in the process of internationalization during the difficult times of global financial crisis. While it highlights the significance of the sector in terms of its contribution to a vibrant industrial economy, the lacklustre performance of SMEs in the export sphere indicates persistence of limitations of institutional support as also those concerning organization of production, including linking to the much-hailed global value chains. Potential business risks and possible ways to manage them have been dealt with in the penultimate section of this paper. The last section is more a reflection on issues rather than a set of conclusions on the problem.

In the Indian context, the adverse repercussion of the global financial crisis on SMEs[1] would have deep impact on a sizeable proportion of the overall economy as this sector continues to be a vital mechanism for generating jobs (across levels of skill, education and age) by, often, using local resources and catering to the varied layers of markets, including the global. As the country has eternally grappled with issues of structural nature, often unsuccessfully, in addressing improving levels of living across space, this sector has contributed immensely towards efforts at reducing regional and rural-urban disparities in growth. As may be surmised from Table 1, there has been a steady rise in the number units which have almost doubled between 1991-92 and 2006-07. Almost similar is the situation for job generation in the sector, which has grown from 16.6 million to 31 million during the same period. Even in terms the value of output of this sector, there has been a four-fold rise.

Table 1: Growth of Small Enterprises in India, 1991–2007

Year	Total SSI Units (in Million)	Employment (in Million)	Production (Rs. Million at Constant 1993-94 Prices)
1991–92	7.06	16.60	0.79
1996–97	8.62	20.59	1.35
2001–02	10.52	24.93	1.96
2002–03	10.95	26.02	2.11
2003–04	11.34	27.14	2.31
2004–05	11.86	28.26	2.56
2005–06	12.34	29.49	2.88
2006–07	12.84	31.25	3.24

Source: Das (2008a: 121).

It needs to be noted, nevertheless, that the official data on small firms have serious limitations insofar as the quality and reliability are concerned. As observed in Das

[1] It be noted that in India, the 'medium' category was formally introduced only recently, in October 2006 when the Micro, Small and Medium Enterprise Development (MSMED) Act was promulgated.

(2006: 113) "scholars have expressed reservations about these figures…. It may be pointed out that the figures for total SSI units have been shown to increase at a specified rate (4.07 per cent per annum); it is not only an unlikely phenomenon, but presents 'grossly inflated' data. Similarly, the production figures of SSIs provided by SIDO, when contrasted with (those) by the National Accounts Statistics (NAS), show gross overstatement in the former source". Limitations of official data have been a serious issue as it camouflages the infirmities of the sector.

Additionally, raising the persistence of the constraint of availability and repayment of credit that has plagued the Indian SMEs for long, it is important to mention at the outset that, irrespective of the global financial crisis, the proportion of net bank credit flows to the small scale sector has been falling in recent years (from 16 per cent in early 1990s to 8 per cent in 2006–2007) (Das, 2008a). Further, the institutional credit sources to SMEs have continued to be marked by the problem of inadequate credit limit sanction, delay in disbursement of long term loans, conservative attitude of the bankers in providing fresh working capital and collateral guarantee, to mention some of the important ones (Morris *et al.*, 2001: 269-271). Inadequate access to timely finance has been one of the important factors responsible for the existence of a considerable magnitude of sickness and failures in the SME sector.

Imperatives of Globalization and Outward Orientation of Indian SMEs

With economic reforms initiated in 1991, the strong currents of globalization impacted the relatively bigger of the small scale sector (the SMEs, in a sense), which had been raring to move from the long-standing regime of import substitution to a phase of export orientation. In the policy spheres, there was a growing emphasis upon enhancing global business linkage to enhance competitiveness, market share and factor productivity. A section of the Indian SMEs was overwhelmed by the hyped charm of neolocalism that underscored success in business as the local interfaced with the global. The policy instruments, as largely spelt through the MSMED Act, reaffirmed this obsession with external orientation, often glossing over the persisting road-blocks as loan-finance, infrastructure and technology support that crippled majority of the small firms.

As it eventually happened, Indian small enterprises posted a lackadaisical performance in the exports sphere, during the post-reforms period. Even as Table 2 indicates a rise in the value of exports from the small enterprise sector, both in current prices and dollar terms, over the period 1990–2006, the trend of annual growth rates of the values (drawn separately in rupee value and corresponding dollar value) for the period reveals a disturbing scenario (Figure 1). Not only that the values have vacillated wildly but also, in certain years, the dollar values have fallen far below those in rupee terms; twice during 1998-99 and 2002-02 the growth rates in dollar values have actually been negative. The unpredictability of the exports belies the growth rates when estimated based on rupee values only.

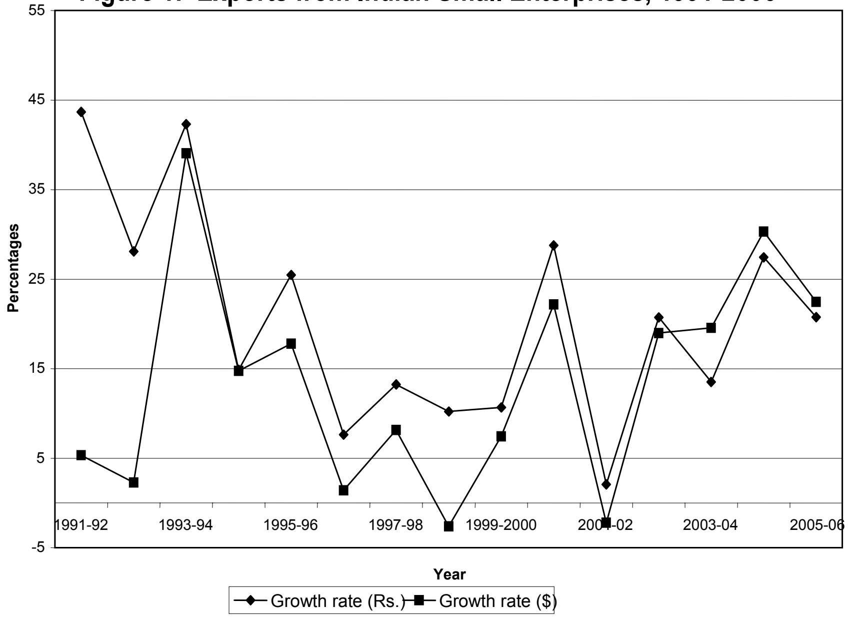
Table 2: Exports from Indian Small Enterprises, 1990–2006

Year	Exports	
	In Current Price (Rs. Million)	In Dollar Terms (Million)
1990–91	966.4	53.9
1991–92	1388.3 (43.66)	56.7 (5.32)
1992–93	1778.4 (28.10)	58.0 (2.29)
1993–94	2530.7 (42.30)	80.7 (39.05)
1994–95	2906.8 (14.86)	92.6 (14.74)
1995–96	3647.0 (25.46)	109.0 (17.77)
1996–97	3924.8 (7.62)	110.6 (1.40)
1997–98	4444.2 (13.23)	119.6 (8.16)
1998–99	4897.9 (10.21)	116.4 (-2.64)
1999–2000	5420.0 (10.66)	125.1 (7.44)
2000–01	6979.7 (28.78)	152.8 (22.15)
2001–02	7124.4 (2.07)	149.4 (-2.22)
2002–03	8601.3 (20.73)	177.7 (18.98)
2003–04	9764.4 (13.52)	212.5 (19.56)
2004–05	12441.7 (27.42)	276.9 (30.31)
2005–06	15024.2 (20.76)	339.1 (22.44)

Sources: Das (2008a: 127).

Note: Figures in brackets show the percentage growth over the previous year. Original data were in Rs. Crore.

Figure 1: Exports from Indian Small Enterprises, 1991-2006



Source: Das (2008a: 128).

Apart from the unimpressive growth rates, even there has hardly been any notable diversification in the product profile, indicating India's poor record in this important sphere of globalization. Indian exports from the small enterprise sector, at least since the late 1980s, continues to be dominated by just eight product groups, (namely, Readymade garments, Engineering goods, Electronic and computer software, Chemicals and allied products, Basic chemicals, pharmaceuticals and cosmetics, Processed foods, Finished leather and leather products, Plastic products) accounting for over 90 per cent of total value of exports. Even in these selected SME sectors, like the pharmaceuticals, for instance, the export share has consistently fallen during the recent years (Pradhan and Sahu, 2008: 45-46). Instead of acknowledging this sobering scenario, often claims made in the official websites project a too-vibrant SME sector without adequate substantiation.

Eventually, the direct impact of economic slowdown in major developed and developing countries are likely to be transmitted to Indian SMEs via international trade. Global credit crunch, falling consumer confidence and spending in foreign countries may result in problems of cancellation/decrease in the number and size of overseas purchase orders and payment defaults. Therefore, export-oriented Indian SMEs who derive significant proportion of their sales from foreign countries are the first to be impacted from imminent global slowdown. This impact seems to be sectorally comprehensive as exporting SMEs in India are dominated in a range of industrial segments like readymade garments and textiles, leather goods, food products, chemicals, pharmaceuticals, engineering goods, and information technologies (IT).

Early signs of contraction in Indian exports are visible in their recent trends. For the first time in the last five years, India's monthly exports have declined by over 12 per cent in October 2008 (US $12822 million) as compared to October 2007 (US $14588 million)[2]. A sharp contraction in exports of readymade garments, cotton clothes and synthetic fibre garments from India has been reported during the same period[3]. Indian gems and jewelry exports have fallen by 34.25 per cent to US $987 million in November 2008 as against US $1501 million recorded in the same month last year[4]. Reports on sharp drop in export orders have been forthcoming in the case of Indian leather products, pharmaceuticals, auto parts and light engineering products. The recent dramatic fall in automobile sales in the US and Europe are clearly forcing global vehicle manufacturers to cut production and reduce sourcing of auto parts from India[5]. Majority of pharmaceutical units in Gujarat—the second important host state to Indian pharmaceutical firms after Maharashtra—are reported to be running below their full capacity due to lack of export orders[6].

With a decline in their foreign sales caused by the slowdown in overseas consumer spending, export-oriented Indian SMEs shall, perfunctorily, attempt to

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[2] http://commerce.nic.in/tradestats/indiatrade_press.asp

[3] Apparel Export Promotion Council (2008) 'Apparel export slips 9.62% in October', December 08.

[4] *Hindu Business Line* (2008) 'Jewellery exports down 34% in November', December 17.

[5] *Hindu Business Line* (2008) 'Auto parts makers see sharp drop in orders from US, Europe', October 12.

[6] *Hindu Business Line* (2008) 'Lack of export orders worries Gujarat pharma sector', December 03.

offset that revenue loss by focusing aggressively on the domestic market. This will result in an increasing pressure on the purely domestic market-oriented Indian SMEs and may, in all likelihood, lead to crowding out as exporting SMEs are relatively efficient and technologically more dynamic than other SMEs just operating in local markets. With substantial growth loss caused by the global economic meltdown, exporting SMEs and large firms are cutting down production and lowering sourcing of products and services from domestic SMEs. Non-exporting SMEs may also be affected as exporting and non-exporting national firms are delaying payment to suppliers of inputs and raw materials.

It is in this broad context of an obsession with external orientation that one needs to bring into focus the growing phenomenon of participation of Indian SMEs in the global value chains (GVCs). In the absence of a reliable information base showing the nature and extent of such contractual arrangements as between multinational enterprises and local firms, it is important to enquire if a substantial proportion of such 'outsourcing' does not amount to what is termed as 'rent-poor' activities. So long as such participation (notwithstanding the miniscule quantum of SMEs joining) in the GVCs has been incapable of building up technological capabilities amongst the in-contracting SMEs, there are reasons to rethink, rather than rejoice, such unhelpful collaboration. Especially at a time of revelations of global financial crisis, the implications for SMEs mostly or wholly tied to 'leading firms' abroad could be serious.

While very little substantive enquiry into the issues of SME participation in the global production systems has been undertaken so far, the MSMED Act, 2006 has made an all-out effort at devising instruments that would help enhancing the competitiveness of Indian SMEs in the global market. The various schemes under the National Manufacturing Competitiveness Council have, in fact, included all possible areas of intervention as, for instance, technology upgradation, quality testing facilities, bar-coding, encouraging participation in global trade fairs and promoting and rewarding entrepreneurial skills (Das, 2008b: 80-84). However, these have essentially remained concerned about a few chosen subsectors, once again missing out an opportunity to broad-base access to these advantages by a large number of product groups as also in all regions, whether rural, semi-urban or urban. As noted in Das (2009: 8), "External orientation and a global outlook for the SME sector must first address persisting basic constraints facing the sector. In the excitement to globalise, including getting networked to the global production networks or value chains, the policy has been heavily biased towards certain limited areas and 'achieving' entrepreneurs and has made inadequate export guarantee provisions. In the absence of a strategy to broad-base business services and infrastructure to tide over domestic market constraints, faced especially by those based in rural areas and small and medium towns, a global meltdown can easily upset the apple cart."

Business Risks and Managing Them

Another important factor that is causing large scale failures in the SME sector is the inability on the part of the firms to go in for an adequate business protection plan to cover a variety of business risks that could be minimized or managed. This factor, which assumes significance during the prolonged phase of the global financial crisis, has been largely under scrutinized in India at both the policy and academic levels while discussing the issues of economic failures in the SME sector. Given that SMEs, specifically smaller firms, operate with a limited resource base, most often just one or two negative shocks are enough to bring sickness (Debroy and Bhandari, 2005: 7-8) and eventual failure to an otherwise well-functioning enterprises. Therefore, it is very important to identify possible negative shocks or business risks that are most predominant among small firms and take appropriate measures to minimize those risks by suitable business protection plans.

Following is a discussion on managing a number of identifiable business risks that can affect revenue and growth of SMEs in India.

Concentrated Demand and Supply: SMEs with excessive dependence on single major buyer or supplier of their key raw materials have the high risk of significant loss of income, which could, eventually, negatively affect their survival chances.

The loss of main buyer or supplier could deal a fatal blow to them. The obvious way to deal with the risks of buyer and supplier concentration is to reduce over-dependence on a single party by diversifying client base and having multiple suppliers. This is purely a firm-specific strategy and SME entrepreneurs should find ways to do that.

Delayed Payment: SMEs often suffer from the problem of late payments for their supply. This is likely to have terrible impact on them as they are perennially suffering from inadequate size of the working capital (Morris *et al*., 2001: 275-280). Recently, there has been a significant attempt at the policy level to protect SMEs from risks of delayed payment. Under Chapter V of the MSMED Act, 2006, SME suppliers should be paid outstanding dues within 45 days from the date of acceptance of goods and services. Otherwise buyers are liable to pay compound interest on a monthly basis to the SME supplier on the outstanding amount from the appointed day and at three times the bank rate notified by the Reserve Bank of India. However, its functioning on a wider scale is still awaited.

Wide Fluctuations in Prices: A sudden upward or downward movement of input prices can have potentially negative impact on the working of SMEs. Rapid escalation in input prices tends to force SMEs to absorb larger part of the rise as they typically fear losing the customer in a competitive market scenario and refrain from factoring in adequate price escalation clause in their supply contracts. Contrarily, a sudden downward trend in input prices can hard-hit SMEs having inventory of high cost raw materials. Particularly, import-dependent and export-oriented SMEs are likely to suffer from increased volatility in currency prices as well. To some extent, SMEs can mitigate risks from the sharp rise in prices of inputs by including mutually agreed safeguard clauses in their business contracts with input suppliers and buyers. Exporting SMEs deriving significant share of their revenues in foreign exchange cash flows are required to adopt selective or complete hedging for foreign exchange risk. A simple way to address this risk is to accept export order in more than one single currency like the US dollar or to enter into forward agreements to convert a given sum of foreign currency into another at a predetermined exchange rate and date or putting an option where the exporting SME has the right but not the obligation to sell currencies at a predetermined date and rate.

Single Promoter and Ignorance about Intellectual Property Rights (IPRs), Environment and Emerging Regulatory Issues: Majority of Indian SMEs have limited number of managerial staff and are mostly run by individual promoters often supported by family members in all aspects of their functioning. This single key individual remains responsible for the financial liability of the enterprise as well as directing its day to day production activities. Clearly, the risk is that the future of the enterprise is wholly dependent upon the well-being of this key business owner.

Further, in a globalized business environment, ignorance of SME managers/entrepreneurs about IPRs, environment-friendly practices and changing legal issues at home and abroad could result in considerable risks and costs to their business. Even unintentional violations of patent rights may entail heavy expenditure associated with legal action which SMEs may not be able to meet. The recent growing incidents of product seizures in the European Union, for instance, of Indian generic drugs consigmments in-transit on suspicious of patent infringement clrealy demonstrate the urgency with which outward-oriented SMEs are required to be aware about patent implications of their business activities[7]. With growing consumer consciousness on product quality, safety, best manufacturing practices and corporate social responsibility on a global scale, SMEs run the risk of losing markets unless they adopt a proactive environmental and manufacturing strategy. Studies have shown that SMEs pursuing weak environmental strategy generally have lower export success than those with green business strategies (Martin-Tapia *et al*., 2008).

The survival risk of SMEs can be minimized by investing in the financial protection for their main promoters essentially for safeguarding business debts, putting in place clear succession plans and employing managers to look after the daily business activities. SMEs also need to keep themselves aware of the IPR

[7] Livemint.com (2009), 'UN agency protests Dutch seizure of Indian HIV drugs', *Wall Street Journal*, March 06.

issues so as to not violate those rights of other firms and adopt best manufacturing practices as per the evolving regulatory regime on health and environmental grounds.

Other Risks: Albeit not specific to SMEs, the productive assets and abilities of these enterprises can also receive impact from risks emanating from natural calamities like cyclone, flood, earthquake and fire. Their business risks can also be caused due to machine breakdown, damage in transportation, maltreating labour, fraud by employees, theft and similar human-made misdemeanours. SMEs also need to get insured for other business risks arising from natural and human-made factors. A comprehensive industrial insurance coverage for all such risks is essential for the overall growth and sustenance of the SME sector in India. Over the last decade, Indian banks and insurance companies have come up to provide different financial protection plans to industrial firms. However, resource constrained SMEs in many cases are either unaware about the possible business risks, or wherever they are aware, have limited financial capability to have a hedged exposure to such risks. Although statistics on the proportion of Indian SMEs going for industrial insurance is not readily available, it can be safe to infer that the SME sector is significantly under-insured as compared to their large counterparts. In this case, policy intervention is clearly warranted to provide cheap insurance provision for risks (as, for instance, relatively lower rate of premium) faced by SMEs and encouraging small firms to be part of a protected financial regime.

In Lieu of a Conclusion

This rather short paper has focused on issues relating to external orientation of SMEs and a few important business risks faced by them during the recent years. These aspects have emerged doubly relevant during the times of global financial crisis that has begun taking its toll on the business dynamism of enterprises, especially the so-called *networked* ones. The Indian SMEs have been under undue duress due to a variety of imperfections in the policy attention towards them; the particularly unfortunate ones have been those discriminated against, hopefully, more by default than by design, due to a certain non-metro location as well as for having been engaged in producing goods not suitable for the global market. Whereas financially well protected Indian SMEs are likely to be more competitive and efficient, a greater recognition of the potential of domestic market and provision of business-facilitating infrastructure holds the key for success of SMEs across board. That could, perchance, be an important strategy to beat the heat of the global financial meltdown.

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