



Economics

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Canadian SMEs—It's Time to See the World

by Benjamin Tal

For the first time in the post-war era, Canada's Small- and Mid-Size Enterprises (SMEs) outperformed their larger corporate counterparts during the last recession. That was thanks to their greater focus on the domestic market, which was less affected by the global downturn. But this sector needs to reorient its attention towards the greater opportunities opening up internationally if it is to maintain its strength and contribution to the Canadian economy during the economic recovery.

The current low level of internationalization among Canadian SMEs carries a significant macro economic cost. Recent trends in SMEs' trade activity and international comparisons suggest that Canadian SMEs have not responded to globalization in a way that optimizes their long-term growth potential and their contribution to the Canadian economy as a whole. Strong growth in emerging markets and increased opportunities to participate in global supply chains due to the greater export orientation of the US economy provide Canadian SMEs with an opportunity to remedy this imbalance.

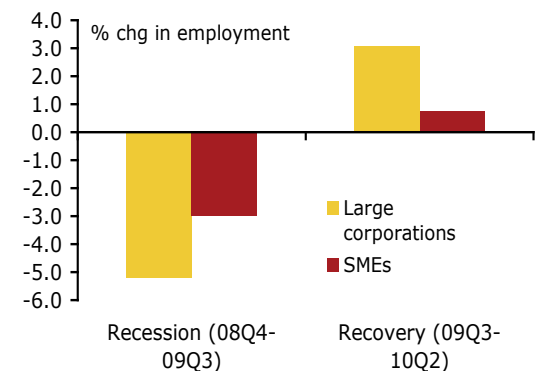
Reversal of Roles

The economic performance of Canadian SMEs' during the recent recession and recovery can be seen as a clear indication that the current economic cycle is far from normal. For the first time in the post-war era, SMEs managed to outperform large corporations during the recession, only to lose ground during the recovery. This is a complete reversal of the traditional cyclical

dynamics in which SMEs underperformed during recessions and outperformed during economic recoveries. This deviation from the traditional trend is very visible in the employment statistics, with SME employment falling much more slowly during the recession relative to the steep job loss experienced by large corporations. But as illustrated in Chart 1, SMEs hardly participated in the recent job market recovery with large corporations responsible for almost all net-job creation since mid-2009.

Key to this reversal of roles is the fact that the recent recession was the first pure global recession — and as a result, Canadian exports fell dramatically — a fact that hurt large firms disproportionately, given their high export orientation. But what shielded SMEs during the recession is impairing them during the recovery. A global recession gave way to a global recovery with exports leading

Chart 1
SMEs Not Participating in Job Market Recovery



Source: Statistics Canada, CIBC

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

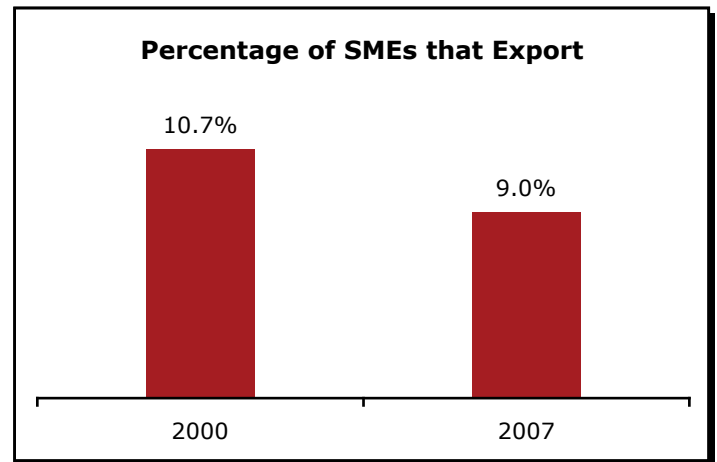
the way (Chart 2). Given this trajectory, Canadian SMEs with their low contribution to exports (Chart 3) were not able to fully take advantage of the improving economic environment.

The Economic Cost

This recent dynamic is a clear illustration of the limitation and significant economic cost of the domestic orientation of Canada's SME sector. Only 9% of Canadian SMEs are engaged in exporting activity², and even this number probably overstates their real international exposure as it includes companies that export sporadically and not as an integral part of their business model. Furthermore, it appears that, despite globalization, the relative number

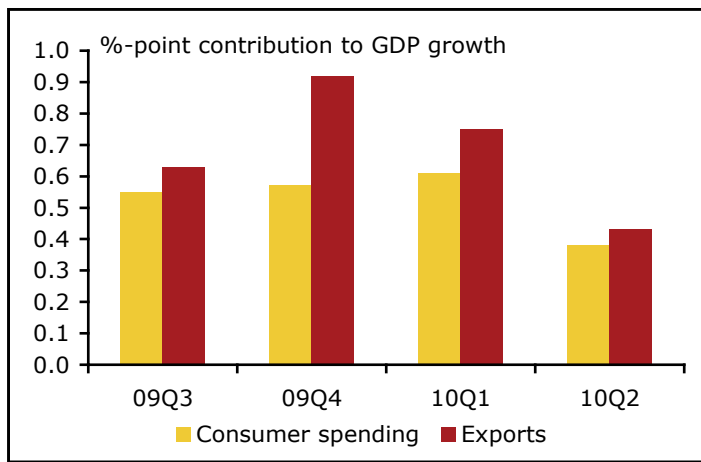
of SMEs that engage in export activity in Canada is, in fact, on a decline (Chart 4).

Chart 4
SMEs Export Activities on a Decline



Source: Statistics Canada, CIBC

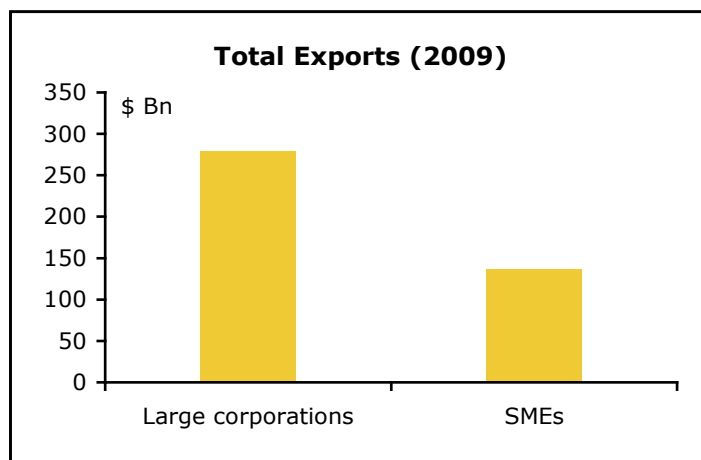
Chart 2
Export Led Recovery



Source: Statistics Canada, CIBC

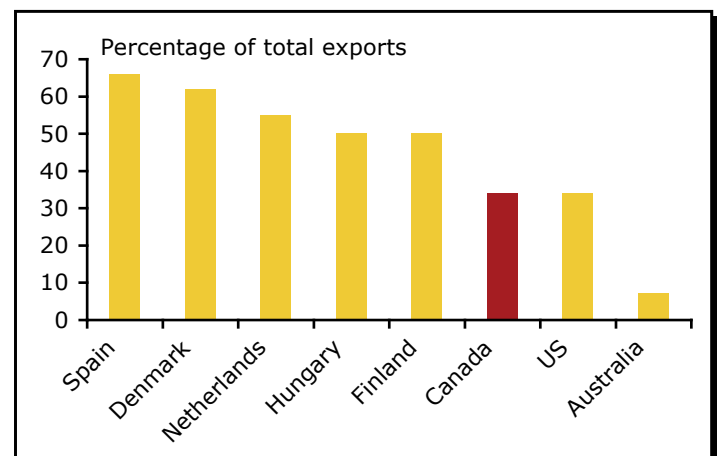
Currently, SMEs are estimated to be responsible for roughly one-third of the total value of Canadian exports with an average value of \$4.6 million per firm. When comparing the contribution of Canadian SMEs to total exports with the performance of their counterparts in other countries, we find, not surprisingly, that Canada is lagging members of the EU as those countries enjoy much lower barriers to trade. Note that the export contribution of Canadian SMEs is much larger than seen in Australia. But the most relevant comparison is of course with the US, where the

Chart 3
Low Contribution to Exports by SMEs



Source: Statistics Canada, CIBC

Chart 5
Percentage Contributions of SME Exports to Total National Exports

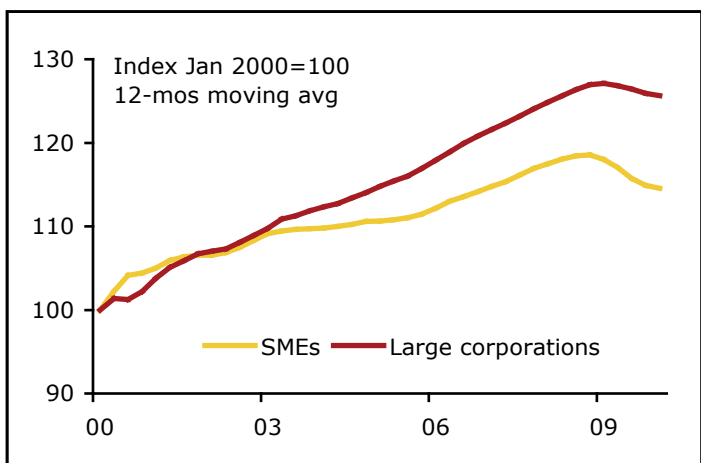


Source: Industry Canada, CIBC

Canadian situation is roughly the same as seen south of the border (Chart 5). While on the surface this seems to be comforting, one should not lose sight of the fact that exports represent 30%-40% of Canadian GDP compared with less than 15% in the US. Given this discrepancy, the export propensity among Canadian SMEs should be much higher than in the US.

And the economic cost of a low rate of internationalization is clear. Recent reports on internationally active SMEs in the EU found that international SMEs create significantly more jobs, and are far more innovative. Similar results were found by Industry Canada in a 2006 report³ which indicates that no less than 65% of fast growing SMEs in Canada were engaged in exports compared with only a third who were domestically oriented. A quick glance at the pace of job creation by SMEs provides a taste of the economic cost. Despite the accelerating pace of globalization over the past decade, the number of jobs created by SMEs has risen by less than 10%. This is half the advance seen among larger firms (Chart 6). With SMEs accounting for just over 40% of the Canadian economy vs. only 30% in the US, this cost associated with a limited international trade activity has significant implications for the nation's overall macro economic environment. We estimate that the moderate decline in SMEs' trade activity during the decade was sufficient to impact no less than 300,000 jobs in terms of actual job loss and foregone opportunities.

Chart 6
SMEs Lag Larger Firms in Job Creation



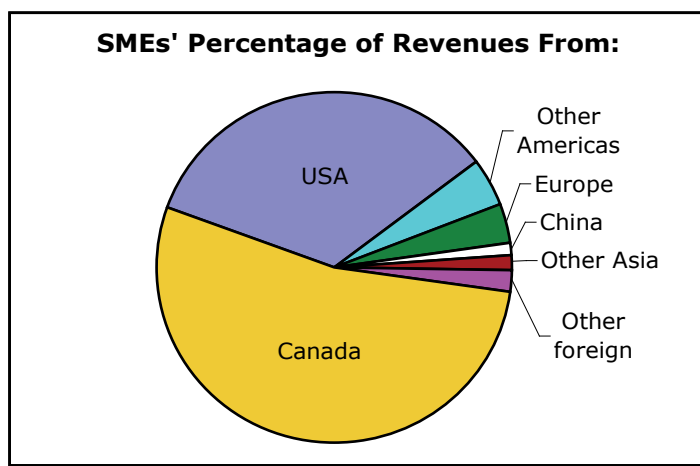
Source: Statistics Canada, CIBC

SME Exporters

Focusing in on exporting SMEs, we find that more than half their revenue is still generated domestically with the vast majority of their external revenues coming from the US (Chart 7). Not surprisingly, even within the SME universe, the propensity to export rises with the size of operation. Less than 10% of firms with fewer than 20 employees engaged in export activity vs. more than 30% among firms with 100-499 employees (Chart 8).

By province, SMEs in Ontario and BC have the highest propensity to export with roughly 10% of SMEs engaged in exporting activity. SMEs in the Prairies are the least

Chart 7
Limited Exposure to Emerging Markets by Canadian SME Exporters



Source: Statistics Canada, CIBC

Chart 8
Propensity to Export Rises with Size

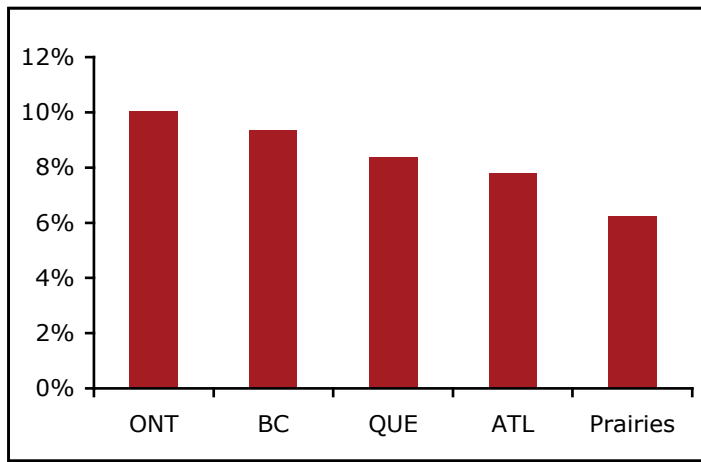


Source: Statistics Canada, CIBC

internationally oriented with only 6% of them selling their products abroad (Chart 9). SMEs in the manufacturing sector have the highest propensity to export followed by knowledge-based industries (Chart 10).

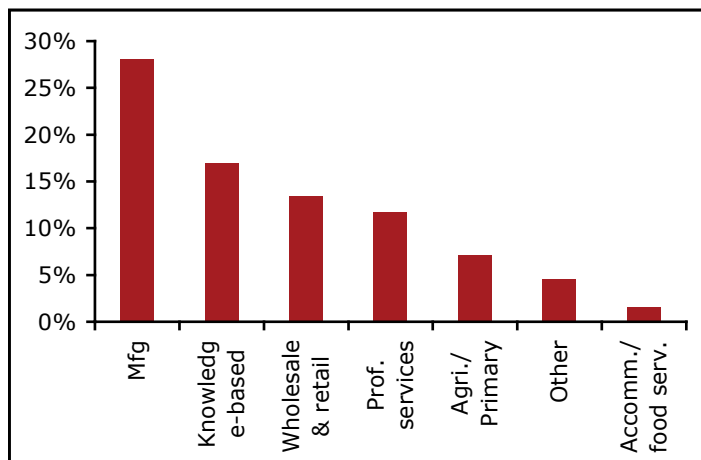
Clearly not all SMEs should be involved in international trade activity. For many of them, the risk and cost associated with internationalization are too high given their limited resources. After all, SMEs involved in international trade face intense competition, multi-national fiscal and regulatory burdens, financing and currency uncertainty, logistic costs and potential cultural barriers. However, recent trends in trade activity among SMEs along with an unfavourable international comparison suggest that

Chart 9
Percentage of SMEs that are Active Internationally



Source: Statistics Canada, CIBC

Chart 10
Percentage of SMEs that Export—By Industry



Source: Statistics Canada, CIBC

the level of internationalization among Canadian SMEs is below the optimal threshold that is consistent with a maximum contribution to the Canadian economy.

Opportunities Ahead

While there are many ways to improve the external orientation of SMEs — a vital one is to increase trade activity with emerging markets. As illustrated in Chart 7, only a small portion of SMEs ship their products to emerging markets. Currently, an estimated 3% and 5% of SMEs’ revenues and jobs, respectively, are directly linked to trade with emerging markets. These numbers are obviously too low given the growing importance of emerging markets in the global scene. And on that front, there is some reason for optimism. One of the most important attributes of SMEs that have been successful in penetrating foreign markets is the international experience of the firms’ senior managers. Given the rising number of new immigrants from emerging markets in general, and China in particular, there is a clear opportunity to capitalize on this trend. Also, contrary to popular belief, firms do not graduate to export markets only after developing an established foothold in Canada. In fact, recent research suggests that “born global” companies are as likely to achieve similar levels of export intensity despite fewer resources⁴.

Another important potential engine of growth for SMEs is participation in global supply chains. The reorganization of production at the international level, through increased outsourcing and the development of global value chains, can and should provide SMEs with new opportunities. The fragmentation of production paves the way to new niches for the supply of products and services where SMEs can quickly take advantage of their flexibility. More specifically, it provides SME suppliers access to global markets at lower costs than those faced by small-scale firms and therefore enhances their internationalization process.

True, participating in global supply chains can bring a host of complex changes to SMEs, such as integrating operations with other players, and weak negotiating positions due to power asymmetry. Therefore, the key to success here is for SMEs to increase specialization and invest mainly in multi-purpose solutions. Furthermore, operating in a relatively familiar business environment can significantly reduce entry barriers and power asymmetry. This is where we see the most significant near-term opportunity for Canadian SMEs given the projected increase of outsourcing activity in the US.

The post-recession reality south of the border suggests that the traditional engines of growth during recoveries (housing and consumer) will not be able to fulfill their usual role. This is already leading to a significant change in the role that business investment and exports play in the current recovery. In fact, for the first time on record, the contribution of these two sectors to overall US GDP growth during a recovery was larger than the combined contribution of housing and consumption. And this process is sustainable. While in previous recessions and recoveries, emerging markets were too small to impact the US economy, that is not the case this time around. Emerging markets now account for almost 25% of global GDP and are almost 80% the size of the US economy. That is large enough to affect the trajectory of US exports. In fact, no less than one-third of US exports go

to emerging markets, and with these markets likely to continue to outpace developed economies, this share will continue to rise.

Increased US exports to emerging markets means increased options for Canadian SMEs to participate in the supply chain momentum that this trend generates. Currently close to 30% of Canada's trade is being sold as inputs into global supply chains. While we do not have good information about the contribution of SMEs to this total, indications are that Canadian SMEs are not seizing the opportunities provided by global supply chains and have limited involvement in them⁵. The changing engine of growth south of the border can provide SMEs with a golden opportunity to become a larger player in this expanding space.

Notes:

1. *SMEs are defined here as firms with less than 500 employees.*
2. *Data on export activity by SMEs was obtained from Statistics Canada: Survey on Financing SMEs and Exporter Register.*
3. *Small Business Financing Profiles, Industry Canada September 2006.*
4. *Canadian SME exporters and CFIB report on trade.*
5. *Golfarb and Beckman, Canada's Changing Role in Global Supply.*

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