

CREATING OPPORTUNITY FOR SMALL-FIRM EXPORTERS THROUGH REGIONAL FREE TRADE AGREEMENTS: A STRATEGIC PERSPECTIVE FROM NEW ZEALAND¹

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ABSTRACT: In the absence of continued progress on world trade liberalisation, regional free trade agreements (FTAs) have gained increased attention. As a small economy, one of New Zealand's key aims is to become a more active participant in the global economy with higher levels of exports. The emphasis on exporting is particularly significant in New Zealand, where the small size of the domestic market makes exporting as a developmental strategy critical. Since 2000, this is reflected in the conclusion of FTAs with individual countries (China, Singapore and Thailand) and as part of a larger grouping (the 'P4' with Singapore, Brunei and Chile) as well as ongoing negotiations to secure other agreements.

This paper reports on a privately commissioned qualitative study based on face-to-face interviews with 51 SME owner-managers most of which were either currently exporters or close-to becoming exporters. The interviews examined current participation in exporting, awareness of the FTAs and the perceived opportunities presented by FTAs.

Looking at SMEs from a strategic perspective, there is general recognition that most SMEs pursue niche strategies: rather than compete head-on with large companies they prefer to seek out specialised opportunities and gaps in the market. The strategy for market niche development suggests that SMEs seek to differentiate their business from each other and from high-volume firms. This paper explores how this is reflected in the reaction to the FTAs by a sample of SME exporters. Most presented themselves as well established exporters with many having direct experience of the economies now included in the FTAs. There was high interest in FTAs and a general desire to see more such agreements concluded, seeing this as an important aspect of expanding opportunity for SMEs. Nonetheless, among those interviewed few planned to change their export strategies because of the FTAs. This finding is explained and linked to the development of typologies of export activity based on niche strategies. Implications for how FTAs might maximise the opportunities for small-firm exporters are suggested in the conclusion of the paper.

1. NEW ZEALAND'S APPROACH TO INTERNATIONALISATION

As in other countries, New Zealand SMEs constitute a significant proportion

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of the business population and as such the sector plays an important role in terms of social cohesion and economic development. In fact 99 percent of all firms (there are approximately 400,000 'economically significant enterprises' in New Zealand) employ fewer than 100 employees and 84 percent employ fewer than 5 (Ministry of Economic Development, 2007). These demographics clearly demonstrate the dependence of the New Zealand economy on the SME sector.

However while these firms play an important role in the domestic economy, few of them export: Just 16 percent of New Zealand firms generate income from exporting, with the majority of these firms being small or micro in size (12 percent). Most export sales are modest in terms of scale with 56 percent of exporters generating less than NZD\$ 5 million in export sales per annum. Of the firms that export goods (as opposed to those that generate foreign exchange earnings through the delivery of services), 88 percent of the firms that export earn less than NZ\$ 1 million worth of exports per annum and altogether these firms account for only 3 percent of total goods exports by value. Only 592 New Zealand firms export more than NZ\$ 5 million worth of products a year, with these firms responsible for 90 percent of exports (Ministry of Economic Development, 2007).

These exports are dominated by primary products which tend to have a lower value than services or more highly processed goods and a higher volatility regarding price variations. The low level of manufacturing exports is also characterised by a low level of technology compared to the OECD average (OECD, 2004). Furthermore, although New Zealand's trade intensity (as measured by export of goods and services + import of goods and services/2 x GDP) has improved over the past 15 years in terms of diversification and value, its exports are still only equivalent to 29 percent of New Zealand's gross domestic product (Statistics New Zealand, 2005). By international standards, New Zealand is not doing well as an exporting nation.

In 2004, New Zealand had the fourth-lowest value of exports in the OECD, higher only than Greece, Luxembourg and Iceland. In the same period (i.e. 2003-2004) New Zealand had the seventh-fastest-growing economy in the OECD, with a growth rate of 4.8 percent. This compares with the 3.6 percent overall economic growth of all OECD countries in the same period (OECD, 2005).

However, as a small economy New Zealand relies heavily on international trade as export performance is regarded as directly impacting on economic growth. The domestic market is simply too small to generate enough economic growth and the distance from major world markets exacerbates the challenges of breaking into and competing within global markets. To counterbalance trends that show that export growth is slipping well behind other developed countries, in 2006 the government launched the 'economic transformation' agenda; a ten year plan with one key aim – fostering internationalisation within the SME sector. Based on this agenda the New Zealand Government has developed a multi-faceted strategy to raise awareness of exporting, provide export assistance to businesses and develop export relevant policy.

This paper focuses on trade agreements as a specific policy measure to make

international trade easier and more efficient. Regional, bilateral and multilateral trade agreements have become an important part of New Zealand's international trade policy. By negotiating Free Trade Agreements (FTAs), the Ministry of Foreign Affairs and Trade aims to improve access for New Zealand exporters and investors into overseas markets, to reduce barriers impeding trade and ensure current access is maintained. FTAs are regarded as essential to ensure the ongoing competitiveness for exporters in key markets. Currently New Zealand has FTAs with Australia, Singapore, Thailand, Chile and Brunei and China, and negotiations for further agreements with Malaysia, Hong Kong, the Gulf Cooperation Council and the Association of South East Asian countries are underway (Ministry for Foreign Affairs and Trade, 2007).

2. BARRIERS TO INTERNATIONALISATION

A number of authors have classified export barriers as they are perceived by SMEs, with considerable variation regarding the number, characteristics, content or impact of barriers to internationalisation (Bauerschmidt et al., 1985; Gripsrud, 1990; Ramaswami & Yang, 1990; Sharkey et al., 1989; Yang et al., 1992). Leonidou (2004) provided the most comprehensive classification of 39 export barriers based on a systematic review of 32 empirical studies.

In this study barriers are defined as “all those constraints that hinder the firm’s ability to initiate, to develop, or to sustain business operations in overseas markets” (Leonidou, 2004, p. 281) and are classified as being on one of four ‘levels’. Starting at the first level (where there is a simple distinction made between internal and external barriers), each of them is then broken down into more specific barriers on each subsequent level. The classification offers practical and analytical strength by collating existing knowledge on the nature of barriers to exporting for small businesses. In addition to the classification itself, Leonidou (2004) offers an aggregate ranking of export barriers on a five point scale from ‘very high impact’ to ‘very low impact’. The barriers associated with a very high impact are: limited information to locate/analyse markets, inability to contact overseas customers, identifying foreign business opportunities, difficulty in matching competitors’ prices, excessive transportation/insurance costs, different foreign customer habits/attitudes, poor/deteriorating economic conditions abroad and political instability in foreign markets.

A recent OECD (2006) study on SMEs perceptions of barriers to access international markets surveyed 978 SMEs worldwide using Leonidou’s (2004) classification. Five of the top ten barriers corresponded with Leonidou’s (2004) category of “very high impact”, namely identifying foreign business opportunities, having limited information to locate/analyse markets, being unable to contact overseas customers, having difficulty in matching competitors’ prices, and excessive transportation/ insurance costs. However, the top ranked factor in the OECD study was the barrier “shortage of working capital to finance export”, a barrier that is judged “moderate impact” in Leonidou’s (2004) ranking. Internationalisation often requires extensive expenditures and can create a financial burden for a small business. For Leonidou (2004) shortage of working capital is an internal barrier, related to inefficiencies of various firms’ functions.

However, the OECD (2006) argues that shortage of working capital to finance exports is not a general issue of accessing finance or inefficient financial functions of a firm, but is a mix of internal and external factors, such as financial management skills, business environment considerations and political risks. Overall there was close agreement between policymakers and SMEs regarding the key barriers preventing SMEs from getting involved in internationalisation. The most significant mismatch in the perception of policy makers and SMEs related to the political, legal and fiscal environment in which they operate.

Another perspective on the relationship between SMEs and exporting is to focus on the process by which SMEs 'learn about' accessing international markets. This approach is based on an assumption that firms at an early, rather aspirational stage in relation to exporting seem to underestimate barriers – both in the business environment and internally. At this stage firms tend to overstate barriers in relation to access to finance and markets. But perceptions of barriers change as firms become more experienced in their international activity. The growing and more complex demands associated with emerging markets mean that any shortcomings in the firm's infrastructure, its resources or its management become more critical. By contrast, access to finance becomes less of a problem, whereas financial management skills gain importance (OECD, 2006).

Another strand in the literature suggests that SMEs with a low level of involvement in international trade perceive exporting as more complex and difficult. Suarez-Ortega (2003, p.413) suggests a "parallelism" between the firm's export development stage and its perception of barriers. Drawing on Ramaswami and Yang's (1990) classification, Suarez-Ortega (2003) finds that in firms where the owner-manager is not interested in exporting, resource barriers are perceived to have a high impact, whereas for those who are interested in exporting (but not yet doing so) knowledge barriers are regarded as most problematic. Firms with considerable export experience tend to show comparably low levels of perceived barriers across all categories.

In summary, the review of the literature shows that the barriers to internationalisation of SMEs are well researched. However, interestingly, with globalisation and the trend towards easing market restrictions through Free Trade Agreements, there is a lack of research on the effects of FTAs on SMEs. This is despite the fact that FTAs have the potential for businesses to enhance their market access, although it might be argued that compared to most larger firms, small and medium-sized enterprises are generally less well-equipped to capitalise on the opportunities to increase international trade.

This argument (i.e. that SMEs are less well-equipped to take advantage of the opportunities to increase international trade) is supported by Campbell (1996) who concludes that FTAs offer new opportunities only to those firms who are able to mobilize the internal resources necessary for greater export activity. Results of Campbell's study showed that a firm's choice to adopt a proactive or a reactive exporting strategy in response to free trade depends upon the perceived importance of free trade to the firm and on the internal barriers faced. Further, it seemed that exporters are making strategic choices about how they wish to

pursue export markets and these choices determine their export strategy rather than tariff barriers. The study further suggests that since small firms may not have the internal resources to launch both offensive and defensive strategies, small firms face the choice between defending their existing export markets and pursuing new export opportunities. Given the influence of internal constraints on the export behaviour, the choice of defending existing markets might be more likely.

Besides Campbell (1996), only two other studies were identified that focused explicitly on the effects of FTAs on SMEs. Julien, Joyal and Deshaies (1994) studied the effects of FTAs on small businesses in three regions in Quebec, Canada. They found that 44 percent of the firms were in favour of the FTA, but only 10 percent had taken steps to capitalise on the opportunities presented by the FTA and a further 22 percent planned to take action. Reasons why such a small number of firms have taken action were that external factors (such as the economic recession, high interest rates, new sales taxes, growth in the industry and the overvaluation of the Canadian dollar) were perceived as having a higher impact on the firm. Access to new markets, lower prices for raw materials and the pressure to become more competitive (which they saw as a good thing) were the main benefits identified by the SME sample. In general, firms that exported or planned to export were more favourable to the FTA than others. Julien (1992 cited in Julien, Joyal & Deshaies, 1994) also argues that tariff barriers might be just one element of small business strategy for survival and development. More common strategies that SMEs use to take advantage of market globalisation include product specificities, use of new technology and innovation, creation of marketing and distribution channels as well as changes in organisation.

Given the importance of Free Trade Agreements for market globalisation and the high numbers of SMEs in most countries, there is a clear gap in understanding the effects of FTAs on small businesses. The purpose of this paper is to contribute to existing research by providing empirical evidence on the approach taken by New Zealand SMEs to international trade and the perception of the firm's owner-managers of the opportunities presented by FTAs.

3. THE STUDY

This study reports on a privately commissioned qualitative study with 51 SME owner-managers employing fewer than 100 full-time equivalent staff (FTE). The sample for this study was selected purposefully using a publicly available export directory. To obtain "formation-rich cases" to "learn a great deal about issues of central importance to the purpose of the research" (Patton, 1990, p169) we have chosen firms at the start of or early stage of exporting, experienced exporting firms and experienced exporting firms that are aware of FTAs. Initially the firms were contacted by phone and asked to participate in our study if they met the appropriate criteria.

Each firm was visited by a member of the research team and the owner (and in some cases the export manager), was interviewed using a semi-structured schedule. Each interview (which was on average one hour), was recorded and the interview transcript was sent back to the interviewee for approval. This

approach followed the guidelines provided by the Massey University Human Ethics Committee which approved the way in which the team planned to select the interviewees and collect and store the data.

The interview schedule was structured into four broad areas. The first section collected general demographic information about the owner and the firm in question. The second section looked at the firm's export practices. The third section looked at how the interviewees started to export, the way they learn about exporting and the extent to which they are engaged with the wider export support infrastructure. The final section examined the owner's awareness and experience with FTAs and their impact on the firm's exports. The data was subjected to formal content analysis.

The 51 firms researched were made up of 17 micro firms (employing fewer than 5 FTEs), 22 small firms (employing 6 to 49 FTEs) and 12 medium-sized firms (employing 50 to 99 FTEs). Of these 36 exported goods and 15 exported services. The average age of all firms was 18 years and the average annual turnover was \$8.2m. The average export experience was of 11 years. In sum the 51 firms interviewed exported goods and services worth \$238m a year, equivalent to an average of \$5.7m per firm. Some of the firms only exported to one country, while others exported worldwide. On average each firm exported to 11 countries.

4. RESULTS

Most of the SMEs that took part in this study regarded existing FTAs as important for New Zealand, but very few could see the relevance of an FTA for their business or how it could have a positive impact on it. Although, most of the SME owners interviewed were not engaged with FTAs, they seemed to be interested and supportive of the government's effort to negotiate further FTAs.

"No, I'd be interested to know what that means. [...] I would like to, you know, maybe read through them and see how that's supposed to work because it may mean that we could do things differently and, you know, save money for our customers rather than just blindly carrying on" (Firm 32).

Most of the owners and/or managers interviewed considered international trade policy and FTA negotiations to be driven by the agricultural sector - mainly the meat and dairy industries - and thus to favour larger firms.

"I think free trade agreements with the other countries are not related to manufacturing. They're related to agriculture and I don't think they're of benefit to manufacturing" (Firm 41).

As well as perceiving FTAs to be relevant to specific industries, three main themes emerged why the interviewed firms did not capitalise on the opportunities provided by FTAs. These were tariff related barriers, non-tariff related barriers and financial barriers.

4.1 Tariff related barriers

The majority of firms interviewed did not face any tariff barriers.

"No, our products don't attract duty" (Firm 32).

A small group faced import tariffs, but they did not have a negative impact

on the business. This was mainly due to the fact that the firms had developed a strategy to avoid the tariffs e.g. by categorising their product differently or by exporting free-on-board shipping, meaning that the buyer is responsible for possible duty.

“Well we personally don’t deal with the tariffs. It’s the buyer that deals with that” (Firm 51).

Only four firms faced tariffs that had a negative impact on their business in terms of making them less competitive. The sector that seemed to be most affected by high tariffs was the wine industry.

“Looking at Thailand it was in the end a reduction in the tariff on the wine, but it wasn’t really helpful. Well it didn’t hurt you know, but if there is a tariff of 420 nowadays 400 it is still a lot of tariff” (Firm 50).

While tariff reductions might have a huge impact on the competitiveness of large firms, it seems that for SMEs tariffs are not the main concern.

4.2 Non-tariff related barriers

Non-tariff related barriers were identified as having a far higher impact than tariff related barriers. These non-tariff related barriers were documentation requirements, unfamiliar business practices and (bio-) security regulations.

“Our biggest barrier to exporting is different regulations around the world, it’s not the tariffs or the import duties, it’s the actual legislation. [...] I have a look at that country first, but then the regulation would then be the determining factor, the regulation” (Firm 52).

“It’s a Muslim country and doing business in Muslim countries is an art form, you have to be very careful what you say, what you do and how you say it. We are slowly learning how to deal with Muslim countries. As you probably already know the hardest job is identifying who is at the top and who is not at the top, and make sure that you get all the ducks in a row, and that takes some doing” (Firm 2).

“One of the biggest problems we’re coming up against in the last 12 months is the new worldwide bio-security law to move equipment around. That is really meant to be one of the most major problems for exporting for us” (Firm 40).

“The post 911 fallout with security has had a big effect as well, just on the sheer difficulty of moving product into the United States from a security perspective” (Firm 39).

4.3 Financial barriers

Besides the tariff and non-tariff barriers, a third category of barriers emerged that present major impediments for exporters. These are not related to FTAs directly, but respondents have attached great importance to them in terms of impact on their export performance. These include the volatility of the New Zealand dollar and the associated problem of receiving support from banks and the taxation of overseas income.

“But the banks generally do not like SMEs; they are not supportive of exporters because we’re exposed to the foreign currency exchange rates so that’s one issue” (Firm 18).

“We don’t have so many issues around tariffs; it’s more around the taxation” (Firm 44).

5. DISCUSSION

Free Trade Agreements (FTAs) aim to improve access for New Zealand exporters and investors into overseas markets, to reduce barriers impeding trade and to ensure current access is maintained. This study showed that although the interviewed firms regarded existing FTAs as important for New Zealand, very few could see the relevance of an FTA for their business or how it could have a positive impact on it. Results suggest that the main barriers SMEs are facing are not related to tariffs or gaining market access. This finding is consistent with a strategic perspective on the competitive strategies most frequently pursued by SMEs. This perspective anticipates that most SMEs pursue niche strategies: rather than compete head-on with large companies they prefer to seek out specialised opportunities and gaps in the market (Katz 1970; Porter 1985; O’Gorman 2000). The strategy for market niche development suggests that SMEs seek to differentiate their business from each other and from high-volume firms. This places a heavy emphasis on individually tailored services and products and marketing that stresses uniqueness and differentiation from standard business offerings. These strategic imperatives are evident in the responses of New Zealand’s SMEs and explains why tariffs and market access might not be the major problems for New Zealand SMEs.

The SMEs involved in this study presented themselves as flourishing and diverse exporters. For most of these firms exporting very early in their development was crucial to achieving growth. Export success was highest in areas of technological innovation, high quality products and the development of niche markets through differentiation.

The small firms we encountered have a variable dependency on exports. Even among those with a high dependency the general situation is that small enterprises are satisfied by small markets. This tends to mean that it is much more uncommon for small enterprises to be constrained by market access than are high volume exporters. An extension of this is that rather than deepening relationships with current markets, many small enterprises are highly mobile in their exporting activity. For example, one exporter we encountered said that they had a network of around 50 overseas buyers interested in their product. In any year they may have capacity to supply no more than 10 of these buyers. This kind of context means that enterprises can have capacity to move product wherever the best opportunities lie rather than being reliant on changes in market access. Comparatively small volumes can also mean the possibility of serving specific market niches that give access to markets that might be blocked to high volume exporters. With limited production capacity, small enterprises are deterred from entering markets where they are unlikely to be able to satisfy customer demand. Similarly, they tend to tailor exporting to markets with least

investment required to access to customers. Both these influences explain why many of the exporters we encountered rely heavily on East Asia's small economies for exports. These are all relatively open economies so that even where a free trade agreement has been included this may not have been recognised with exporters.

It is also important to recognise that exporting involves varying levels of interaction with overseas markets. At the extremes, for example, an internet trader may typically sell directly to end buyers who purchase in small parcel-size volumes. Exporting can simply mean mailing to an overseas address rather than a domestic one with the 'exporter' having little or no familiarity with the destinations to which their goods are dispatched. Distribution through normal or courier delivery systems can mean that exports generally slip under the radar screen of overseas customs and other regulatory authorities. One step removed from this are the many exporters who work through overseas agents who take all responsibility and cost for clearing goods in the overseas market. Exporters can operate with little awareness of market access issues or other peculiarities of individual markets, rather the focus may simply be on gaining the support of overseas distributors wherever they are located. Consequently while it might be thought that exporters are highly knowledgeable about market access issues and are actively pursuing guidance and market information, this is not necessarily a requirement of all exporters. Many of the exporters encountered in this study come within this category.

For those exporters who do engage with buyers in their export markets, it is important to distinguish 'market specialists' from those with variable markets. The market specialist dedicated to serving a particular market has scope to adjust investment to the needs and opportunities arising in the overseas market. The exporter that sells to markets that differ from one year to the next has less scope to learn about and adapt to market impediments. This type of exporter, depending on the markets of interest and type of product or service sold, has more chance of being concerned about market barriers and free trade negotiations than the specialist exporter. Indeed it is hard to imagine a specialist without them having resolved a method for effectively dealing with their market of interest. We interviewed relatively few enterprises that have a shifting market focus and this again needs to be recognised in the profile of responses obtained.

6. CONCLUSION

It is well recognised that internationalisation is of growing importance to the success of small economies and one indicator of this is higher levels of exports. The emphasis on exporting is particularly significant in New Zealand, where the small size of the domestic market makes exporting as a developmental strategy critical. The current government's focus on 'economic transformation' has led to the establishment of a multi-level approach, which includes the establishment of Free Trade Agreements (FTAs) between New Zealand and a range of other countries. These agreements are designed to make international trade easier and more efficient and over recent years they have become an important part of New Zealand's international trade policy.

This paper has indicated that FTAs can present business opportunities for SMEs, but that frequently SMEs are unable to incorporate them into their export practice. The reasons for this are related to the very nature of SMEs. To engage in international trade SMEs need to invest significant amount of time and resources when at the same time facing financial and human resource constraints. Typically, the owner and/or manager of an SME combines technical, business and export knowledge and expertise, and they are the most important drivers in the export development process. Some of these individuals may have a formal export strategy, but others develop their export business as opportunities arise. Although this reactive approach to opportunities is often criticised, it works well for small firms which are resource constrained, but flexible and able to respond promptly to opportunities.

Finally, this study suggests that to bring greater, immediate benefits to SMEs the priorities in future free trade negotiations may need to be modified. Regional FTAs so far concluded are generally viewed as positive but without offering benefits for existing SME exporters and this implies that they will have little impact on breaking down the barriers faced by the larger population of still-to-export SMEs. NZ is continuing to seek to make new trade agreements and deepen existing ones. Broad principles to guide trade negotiators and trade promotion agencies seeking to enhance the gains for SME exporters include:

- Seeking to formalise the opportunity for small volumes to be excluded from regulations that otherwise would present insurmountable barriers.
- Develop administrative processes to assist the access for frequent small scale exports which may be jeopardised by compliance costs associated with trade regulations.
- Recognise that for many SMEs the certainty and clarity of market access rules are often a bigger concern than the absolute levels of tariffs.

At the broadest level it would also appear that for many SMEs small improvements in the access to high income markets may be of greater value than giving priority to securing large gains in the access to low income markets.

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