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White Paper

No Such Thing as a Commodity

Routes to higher value added for SMEs in developing and least developed countries

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Foreword

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Small and medium-sized enterprises (SMEs) have a central role to play in achieving the aim of inclusive economic growth within the Sustainable Development Goals. SMEs constitute the backbone of most economies, representing the majority of firms and the principle source of employment. The degree to which they are competitive and able to innovate will determine the success of developing and least developed countries in reducing poverty. Most SMEs in these countries are in commodity-based sectors, where volatile international markets determine the value of their output. Unable to differentiate themselves, these small producers receive only a minor share of the final price at which their products are sold.

The degree to which countries depend on commodities correlates with poor performance on a range of development indicators. For this reason, governments and international organizations alike have promoted economic diversification towards non-commodity sectors, including services and manufacturing activities linked to global value chains. Unfortunately, this does not automatically lead to escaping the trap. If these activities are low value added and undifferentiated from the output of other countries, they, too, can become another form of commodity.

If mechanisms can be found for large numbers of small firms to improve and innovate their products and services, share solutions for transforming, exporting and commercializing what they produce, and connect more directly with end customers, then a significant contribution could be made to reducing their dependency on commodities.

This White Paper takes its inspiration from the management lesson offered to large firms over the last 50 years: that all products and services can be differentiated through innovation and by practising good business and marketing principles. Recognizing that much has changed over the last five decades, particularly with the rise of globalization and digitalization, the paper asks what small firms can now do differently, and what aspects of this change are applicable to developing and least developed countries.

To investigate this potential, the authors propose a framework to categorize the different paths to higher value addition that may be open to SMEs, using success stories to illustrate the approaches and show potential for wider innovation. The paper then summarizes the findings into recommendations for policy-makers, development actors and firms looking to support SMEs towards this destination.

Introduction

"There is no such thing as a commodity. All goods and services are differentiable," wrote management theorist and author Theodore Levitt in 1980.[1] Originally addressed to American and multinational enterprises, this rallying call for innovation is the inspiration for this White Paper, which examines how the same rationale applies to the challenge of reducing dependency on commodities in developing countries. If all goods and services can be differentiated, then perhaps new approaches for doing so are still possible after 40 years of innovation in global trade and technology.

When Levitt issued his polemic, enterprises were suffering from the early stages of globalization – namely, increased competition and eroding margins. The solution was to better understand and serve distinct market segments, differentiate through improved products and services and later outsource non-core functions to local and offshore partners. The lessons, however, have not been sufficiently applied by the many small and medium-sized enterprises (SMEs) that make up the backbone of most economies. SMEs contribute more than 50% of employment and 40% of gross domestic product (GDP) in developing countries.[2] Improving their value added and profitability can have a significantly positive spillover effect[3] on economies and communities.[4] Properly equipped and supported, small firms can pursue a path of becoming less dependent on commodities.

Box 1: What is a commodity?

The term "commodity" is used in a technical sense to cover products from the primary sectors of the economy – farming, forestry, fishing and extractive industries – where all or most value addition has occurred in that sector. In marketing terms, it refers to a service or good, sold on its purely technical characteristics, that is not significantly differentiated from equivalent competitive offerings. Thus, it is generally not branded. Yet a commodity – mangoes, for example – can be differentiated through marketing, such as via branding and packaging, and sold at a premium to undifferentiated competitors.

Commodity dependence occurs when commodities are the main source of export revenue – that is, when commodity exports account for more than 60% of a country's total export merchandise value. Commodities' value can fluctuate significantly (as much as 50% a year), significantly affecting national revenue in commodity-dependent countries.

Sources: United Nations Conference on Trade and Development (UNCTAD) STAT, *Free Market Commodity Price Index: Methodological Note*, 17 May 2018, https://unctad.org/en/PublicationsLibrary/statcpbmn1_en.pdf; UNCTAD, The State of Commodity Dependence 2016, 2017, https://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=1883.

Commodity dependence can result in cyclical downturns, unstable levels of investment, low-paying jobs and poor development outcomes for life expectancy, education and income per person. About 68% of the world's developing countries depended on commodity exports in 2014-2015, while approximately two-thirds of them recorded a low or medium human development index in 2014.[5]

Effective national policies and good governance have helped some countries achieve balanced economic growth despite their significant dependence on commodities. For example, in Chile, copper remains an important source of revenue, accounting for about 46% of the country's exported goods in 2016.[6] The government has taken measures, however, to improve macroeconomic stability; encourage trade; invest in infrastructure, employees and entrepreneurship in non-extractive sectors; and diversify the economy. Its National Innovation System develops and implements innovation policies and initiatives financed by copper royalties.[7] Chile is one of the strongest economies in Latin America in terms of GDP per person[8] and human development.[9]

Commodity-dependent countries have pursued different paths to diversify their production and seek routes to higher value added. Macroeconomic policies have favoured investments in high-tech manufacturing and services, as well as the promotion of investment by lead firms in global value chains (GVCs). Participation in GVCs could promote specialization among SMEs, encourage investment and improve competitiveness and access to international markets.

Such policies have been somewhat successful at diversifying economies and creating jobs in new sectors. Nevertheless, the debate goes on about how much GVCs can be solely relied on to lift countries towards developed status.[10] Commodity-dependent countries must consider how to create and retain more value for their production, irrespective of how much their economies have diversified.

This paper reviews the effect of digitalization and globalization on new paths to higher value added. Through more sophisticated production, marketing and distribution, commodity producers can differentiate their output, position themselves in developed markets and reduce or eliminate the connection to commodity market prices. The paper seeks to show this potential via case studies of firms; these examples, in turn, infer recommendations for policy.

Digital technology and communications have revolutionized how procurement, production and trade are organized. In principle, any firm, large or small, can procure its inputs from the most competitive supplier, trade online with the highest-value customer and optimize production operations through digitalization. Decades of globalization have created networks of suppliers that can provide world-class inputs, reducing the need to invest in every step of production and distribution.

Recognizing this potential and the mechanisms through which firms can pursue higher value added is only the beginning. Governments and development partners need to engage in developing capacities – and providing access to finance – to enable SMEs to pursue a path to higher value added.

Routes to higher value added

Global value chains (GVCs) offer small and medium-sized enterprises (SMEs) the opportunity to become more fully integrated in the global economy. Instead of manufacturing entire products from scratch and carrying all the associated costs, small firms can simply perform one step of a wider production process. Specialization can create the conditions to invest in quality and innovation, thus driving increased value.

The value retained by small firms within these GVCs, however, depends on where they sit along the chain. For example, producing a complex piece of technology often begins with research and development (R&D) and product design. These high-value tasks demanding advanced skills are typically the core competence of international firms and are conducted from headquarters. Manufacturing the product and assembling its components often take place in developing countries, where unit labour costs are low.[11] Marketing, sales, distribution and after-sales services may be conducted through partners in the value chain but are typically tightly controlled by the lead firm and occur in more developed economies closer to the end consumer.

This process is summarized in a simplified abstraction known as the “smiling curve” (see Figure). First espoused in 1992 by Acer founder Stan Shih, the curve is used to review the strategic positioning of information technology (IT) manufacturers in Taiwan, China within global production chains.[12] The smiling curve suggests that most of the economic gain from the value chain occurs during product innovation or in later stages closest to the end customer. The lowest economic value is in the production of goods or commodities, signified by the droop in the middle of the curve.

Unfortunately, SMEs tend to operate in the domestic informal sector in most developing countries and are “price takers” for their goods (i.e. market participants that cannot dictate prices). If they do participate in global networks, it is largely in labour-intensive and low value-added production areas, such as agriculture or low-tech manufacturing. Producing commodities is equivalent to sitting at the bottom of the smiling curve.

Figure: The smiling curve and five routes to higher value added