

»» SMEs exporting to the USA: innovative high performers

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Concern has grown among German businesses over protectionist measures under the new US trade policy. They export more goods to the USA than to any other country – nearly EUR 107 billion in 2016. The USA is also the most important market for German businesses' trade in services.

For German SMEs in particular, exporting to the USA is associated with relatively high additional costs – from entering the market to setting up a sales network and complying with legal provisions. Nevertheless, almost one in six internationally active SMEs export products to the USA. Around 100,000 SMEs generate turnovers totalling EUR 30 to 50 billion on the western side of the Atlantic. That makes the USA the most important export destination of German SMEs outside Europe.

SMEs exporting to the USA are relatively often manufacturers. They are particularly high-turnover, internationally oriented and innovative companies. Half of them offer individual products or services tailored to the customer's needs. Many SMEs doing business in the USA are therefore quite well positioned. The growing rejection of free trade in the USA and elsewhere should nevertheless be taken seriously, and protectionist tendencies should be firmly countered.

New US trade policy ...

As the new US administration took office in January 2017, the country also changed the course of its trade policy. While Obama advocated a transpacific (TPP) and a transatlantic free-trade agreement (TTIP), Trump signed an executive order to remove the US from the TPP only three days into his presidency. The TTIP negotiations between the USA and the European Union have been put on hold. And at the last meeting of the G20 in mid-March, US resistance blocked a clear commitment to free trade from the most important industrialising and emerging economies.

Instead, the US administration's proposal of a border tax adjustments (BTAs) which could be introduced in the context

of a comprehensive corporate tax reform has not been finally abandoned. It would exempt export earnings of US enterprises from taxation. However, enterprises would not be able to deduct the costs of imports. That would equate to subsidising exports and taxing imports.¹ This way, the US trade deficit should be reduced. In 2016 the country exported around USD 502 billion less in goods and services than it imported.²

... could also hit the German economy

Germany also contributes to the US trade deficit, with around USD 65 billion in 2016.³ Trump has criticised this on numerous occasions and raised concerns over an increase in US trade barriers. In Germany, that could primarily affect exporters.

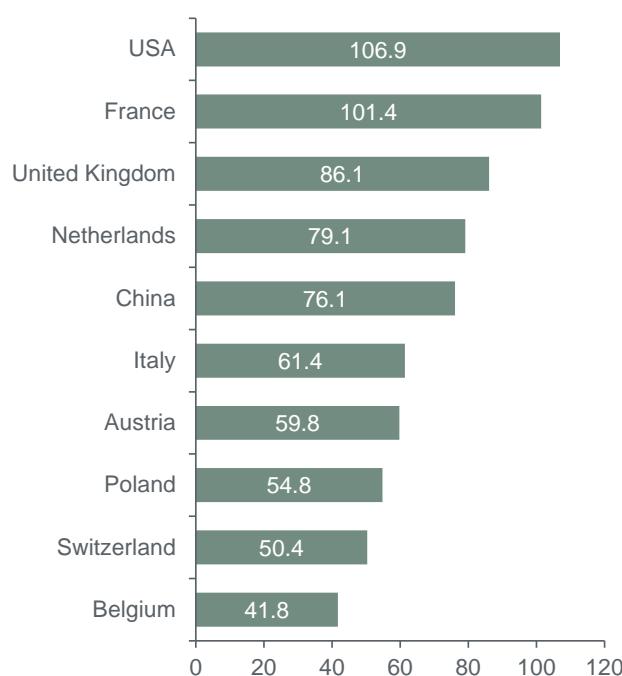
This has prompted us to take a closer look at the trade relations of German businesses with the USA. Our analysis will focus on small and medium-sized enterprises (SMEs). How many SMEs are doing business in the USA? What are their distinguishing features? And what risks might the new US trade policy hold for them?

Germany exports more to the USA than to any other country

The USA is the most important export market for German goods. In 2016, goods exports to the USA amounted to nearly EUR 107 billion, around 8.9 % of total German goods exports (Figure 1). The automotive industry took the greatest share with around EUR 29 billion, or nearly 28 %. German automakers generate almost 13 % of their export turnover in the USA. The country is also a very important sales market for the pharmaceutical and engineering industries (see table).

The USA is also the most important target country for service exports. In 2016 around EUR 41 billion or nearly 16 % of all German service exports went to the USA.⁴ Business-specific services play by far the most important role, especially research and development services, which totalled some EUR 7.2 billion.

Figure 1: USA is most important export destination



German goods exports to the ten main export countries in 2016, in EUR billions.

Source: Destatis

Table: Automotive industry most active

Sector	Share of sector in total German goods exports to the USA	Exports to the USA as a percentage of total exports of sector
Automobiles and parts	27.6%	12.9%
Machines	16.0%	10.1%
Pharmaceutical and similar products	12.0%	18.2%
Data processing equipment, electronic and optical products	8.9%	9.6%
Other vehicles	6.5%	11.6%

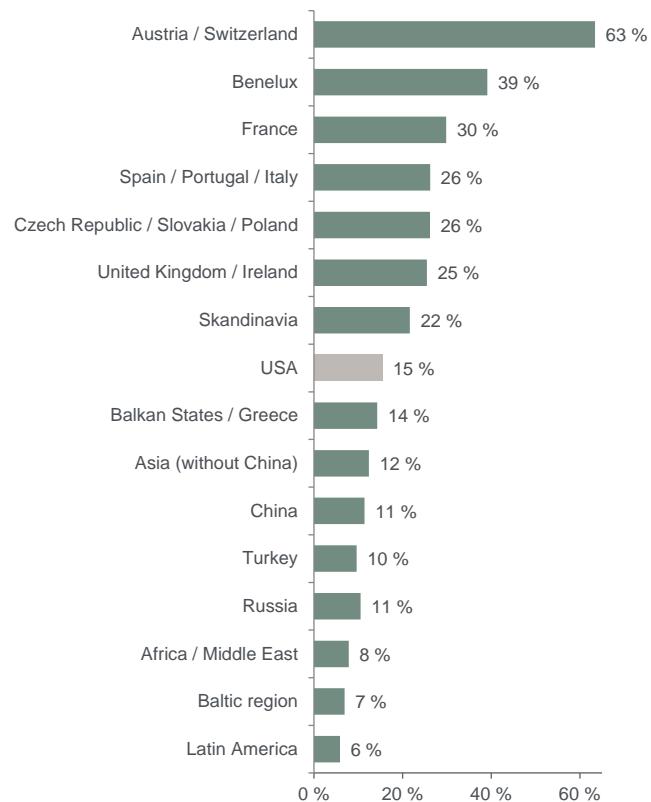
Data for 2016 for the five sectors that make up the largest share of German goods exports to the USA and for which exports to the USA have the biggest share in the sector's total exports.

Source: Destatis

For SMEs, the USA is the most important target country outside Europe

It is true that large-scale enterprises and multinationals are the main drivers of these exports. But there are also a considerable number of SMEs with exports going to the USA. Around 100,000 small and medium-sized German enterprises generate some of their turnover in the USA – that is almost one in six firms with international operations.⁵ SMEs' total turnover in the USA can be estimated at 30 to 50 billion euros.⁶ That makes the USA the most important export market for German SMEs outside Europe (Figure 2).

Figure 2: For German SMEs, the USA is the most important sales market outside Europe



Percentage of exporting SMEs that generated turnover in the target region in 2015. Without sector "Others".

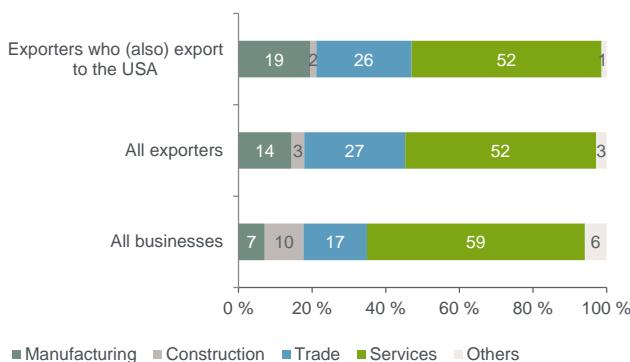
Source: KfW SME Panel 2016

Almost all German SMEs operating in the USA also export to other target regions listed above. More than 90 % of them sell their products or services in other European countries and some 76 % deliver them to at least one emerging or developing economy. On average, SMEs that export to the USA are active in seven other target regions. SME exporters that do not target the USA, in turn, deliver to fewer than three different external markets on average.

Many SMEs exporting to the USA are manufacturers ...

An above-average proportion of SME exporters are manufacturers. This applies in particular to businesses with operations in the USA (Figure 3). Around 7 % of all 3.65 million SMEs in Germany belong to the manufacturing sector. If we consider only the exporters among them, the proportion of SMEs in the manufacturing sector is twice as high, at 14 %. And of the exporting SMEs that deliver to the US market, nearly one in five operate in the manufacturing sector. By comparison, SMEs in the construction sector have relatively little business in the USA.

Figure 3: Manufacturing SMEs are particularly active in the USA



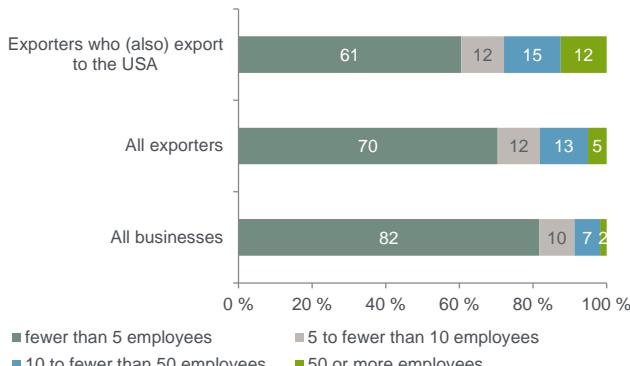
Sectoral distribution by export status in 2015.

Source: KfW SME Panel 2016

... and are larger than other SMEs

Significant differences also exist with respect to company size. If exporters are more common especially among the larger SMEs, this applies even more to exporters targeting the USA (Figure 4). Overall, only around 2% of all SMEs have more than 50 employees. Of the SME that export, no fewer than 5% fall into this size class, and of the ones that (also) export to the USA, the proportion of businesses with more than 50 employees is even 12%.

Figure 4: Larger SMEs more likely to export to the USA

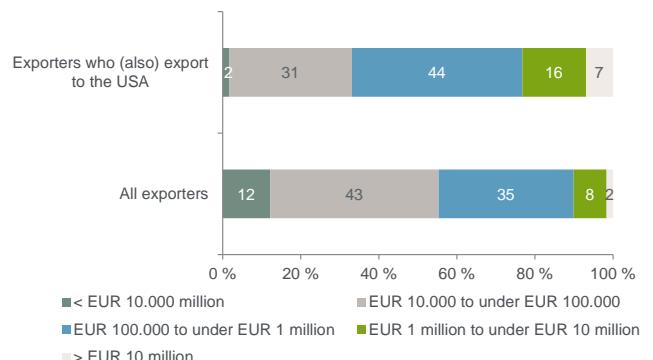


Size class distribution by export status in 2015. Without sector "Others".

Source: KfW SME Panel 2016

SMEs exporting to the USA are also bigger than the average measured by their international turnover (Figure 5). Nearly one fourth of them generated international turnover of EUR 1 million or more in 2015. If we include all SMEs doing business abroad in the analysis, only one in ten SMEs achieve such high international turnover.

Figure 5: SMEs doing business in the USA are export heavyweights



Size class distribution on the basis of international turnover in 2015. Without sector "Others".

Source: KfW SME Panel 2016

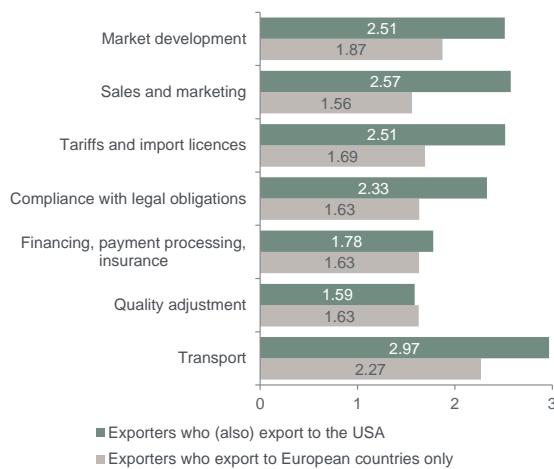
Compared with the total number of enterprises with international business, those exporting to the USA generate not just higher international turnover but also a larger portion of their total turnover abroad – almost 45 % instead of 27%.⁷

For SMEs, exporting to the USA involves relatively high additional costs

The fact that the propensity to export rises with the size of an enterprise can be attributed primarily to economies of scale. Tapping into an external market usually involves additional costs including market research, the establishment of a sales network and adapting products to the target country's technical norms and standards. Many of these costs are fixed or periodic, making an entry to the market worthwhile only upwards of a particular sales volume and, thus, from a certain enterprise size.

It is much more difficult for SMEs to tap into US markets than into other European markets. This is shown by the fact that more than six times as many exporters are active on European markets as in the USA – around 95 % compared with 15 % of all internationally active SMEs. Besides, SMEs operating in the USA perceive the additional costs of exporting as more burdensome than SMEs exporting exclusively to European countries (Figure 6).⁸

Figure 6: Additional cost of doing business abroad for German SMEs is higher in the USA than in Europe



Average significance of various additional costs of doing business abroad for exporting SMEs depending on whether they are (also) active in the USA. Possible answers range from (1) additional costs of doing business abroad do not play a role at all to (5) additional costs of doing business abroad play a very big role. Without taking into account exporting SMEs doing business in emerging or developing markets. Without sector "Others".

Source: KfW SME Panel 2016

Sales and marketing in the USA are high cost items

The differences in the cost of market development, sales and marketing are particularly pronounced. With 320 million consumers and a gross domestic product of USD 18.6 trillion, the USA is an immense but extremely complex sales market. For SMEs active in the USA, the costs of legal compliance also play a relatively big role. The US legal system differs from the European legal system in many ways. Requirements are complex and often differ from one state to another. Technical norms and standards that are largely unified in the European Union differ from those applicable across the USA.

To a large extent, these costs accrue regardless of how much a company sells in the USA. The expenditure is not worthwhile for many smaller SMEs that generate little turnover in the USA. They focus their export activities on markets that are more readily accessible in Europe or desist from exporting altogether.

Tariffs and transport costs make exports to the USA costly as well

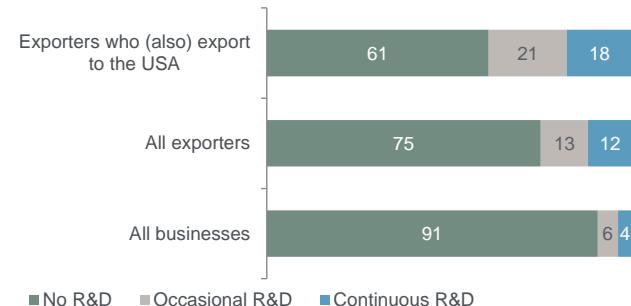
Tariffs are also a higher burden for SMEs exporting to the USA than for those exporting exclusively to Europe.⁹ The geographic distance ultimately means that transport costs also play a much greater role for exports to the USA than to other European countries.

Adapting the quality of products or services, on the other hand, does not incur any higher costs. This reflects the fact that most German SMEs focus on high quality and not on low prices to assert themselves against global competitors.¹⁰ This enables them to also satisfy demanding buyers in a highly developed industrial country such as the USA. SMEs also do not regard funding and insurance as greater obstacles for business on the western side of the Atlantic than for exports to European countries.¹¹

SMEs with business in the USA are particularly innovative

The research and development focus shown by the statistics on exports of services is also reflected in the data pertaining to SMEs. Small and medium-sized exporters who are active in the USA conduct their own research and development more often than the average – nearly one fifth of them continuously and a further fifth at least occasionally in the period from 2013–2015 (Figure 7). The share is significantly lower for the average of all SME exporters. If we include SMEs that do not export, only one in ten enterprises conduct own research and development continuously or occasionally.

Figure 7: Strong in research and development

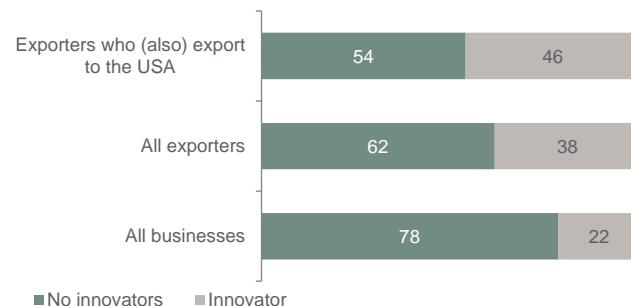


Percentage of enterprises that conducted own research and development occasionally or continuously in 2013–2015 by export status. Without sector "Others".

Source: KfW SME Panel 2016

In line with these findings, there is also a higher proportion of enterprises that introduced a product or process innovation in the 2013–2015 among those SMEs that exported to the USA. Nearly half of them were innovators, while the share of innovators among all exporters was at 38. Considering all 3.65 million SMEs and hence also non-exporters, only about 22% of them introduced a product or process innovation in 2013–2015 (Figure 8).

Figure 8: SMEs exporting to the USA more likely to innovate



Proportion of enterprises that introduced a product or process innovation in 2013–2015 by export status. Without sector "Others".

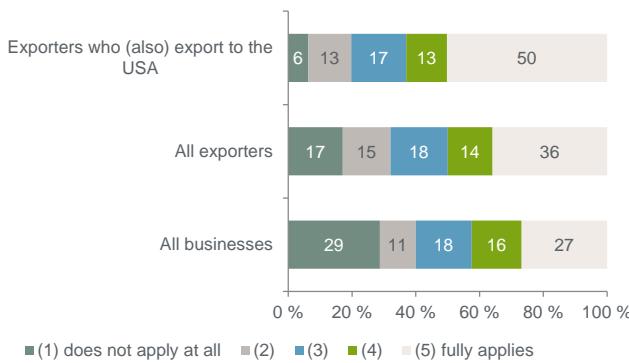
Source: KfW SME Panel 2016

Many enterprises exporting to the USA offer customised products or services

In global competition, German SMEs focus not just on quality and innovation. Particularly in the USA, they often provide products or services that are tailored to the individual needs

of their customers, combining them with the necessary advice and service. High-tech machines for industrial production are an example of this. To put this in figures, around 27% of all SMEs, exporters and non-exporters, regard the fact that they offer their customers unique products or services as an important competitive advantage of their business. In comparison, a good 50% of SMEs doing business in the USA see this as an important factor for their success (Figure 9). By contrast, only 3% of them consider lower prices a decisive competitive advantage.

Figure 9: Competitive advantage due to customised products and services



Proportion of enterprises whose answers to the statement "unique products and/or services (e.g. crafted to meet individual needs) are an important competitive advantage for our business" range from (1) "does not apply at all" to (5) "fully applies". Without sector "Others".

Source: KfW SME Panel 2011/2016

This puts many SMEs in a good starting position since there are most likely only few alternative suppliers from which their customers could source individually tailored products or services. If a higher tariff were to be imposed on their product or service in the USA, they would not have to expect a drastic fall in demand.

Conclusion

For SMEs, doing business in the USA involves relatively high costs. Tapping into the US market, setting up a local sales network and meeting legal requirements is much more difficult than on European markets. Tariffs and transport costs are also significantly higher. Nevertheless, the USA is an attractive sales market for around 100,000 German SMEs, which generated a total turnover of EUR 30 to 50 billion there in 2015.

These enterprises have some particular features. Relatively many of them are manufacturers. They are bigger than the average SME and particularly strong in exporting. Half of them have brought forth innovations in the past and distinguish themselves in the market with individual products or services tailored to the needs of their customers. SMEs exporting to the USA have a higher than average equity ratio of around 38%, which underscores their good starting position.

Inferring from this that German SMEs can remain unperturbed about changes in the US trade policy could nevertheless prove to be a mistake. Many SMEs are not directly involved in exports, but indirectly through their German customers.¹² The consequences of protectionist measures could thus also affect a broad range of smaller SMEs, especially when they give rise to serious trade conflicts.

The new US administration has not yet imposed any specific measures to restrict trade. Still, the fact that a clear commitment to free trade by the most important industrialising and emerging economies has been blocked by the USA resistance is a bad sign – also for German SMEs. ■

¹ For a more detailed analysis of border tax adjustments (BTAs), see Hufbauer, G. C. and Z. Lu (2017): Border Tax Adjustments – Assessing Risks and Rewards, Policy Brief 17-3, Peterson Institute for International Economics Policy, and Peters, H., Rakau, O. and Schneider S. (2017): Risiken für den Export – trotz unterstützender EZB (*Risks to exports – despite support from the ECB* - our title translation), Deutsche Bank Research (in German).

² See U.S. Census Bureau and U.S. Bureau of Economic Analysis (2017): U.S. International Trade in Goods and Services, December 2016, CB 17-17/ BEA 17-06/ FT-900 (16-12), available at <https://www.bea.gov/newsreleases/international/trade/2017/trad1216.htm>.

³ These figures refer only to trade in goods. The most current available data for trade in services relate to the year 2015, when the US deficit with Germany was around USD 1.9 billion. See U.S. Bureau of Economic Analysis (2016): U.S. Trade in Goods and Services by Selected Countries and Areas, 1999–present, available at <https://www.bea.gov/newsreleases/international/trade/2017/trad1216.htm>.

⁴ See Destatis and Deutsche Bundesbank (2017): Außenhandel und Dienstleistungen der Bundesrepublik Deutschland mit dem Ausland – Integrierte Daten für den Berichtszeitraum 2011–2016 (*Cross-border trade in goods and services of the Federal Republic of Germany – Integrated data for the reporting period 2011–2016* – our title translation, in German).

⁵ This paper follows a relatively broad definition of SMEs. It includes all enterprises with an annual turnover of up to EUR 500 million. Cf. Schwartz, M. (2016): KfW SME Panel 2016 – Businesses are using their financial strength, but not boosting investment, KfW Research, Frankfurt am Main.

⁶ It is not possible to break down SMEs' international turnover in detail according to the target regions mentioned. But based on the assumption that the percentage of exports to the USA in total German exports can be applied to the SME sector, the USA accounts for around 8.9% of German SMEs' international turnover. Another study estimates that only around 6% of SMEs' export volume goes to the USA and Canada, but that study is limited to small and medium-sized enterprises with fewer than 250 employees (cf. Söllner (2016): The German Mittelstand in the age of globalisation, Federal Statistical Office, Wiesbaden). If we take this as a point of reference and consider that SMEs' total international turnover in 2015 was EUR 546 billion (cf. Cf. Schwartz, M. (2016): KfW SME Panel 2016 – Businesses are using their financial strength, but not boosting investment, KfW Research, Frankfurt am Main), the turnover of German SMEs in the USA is estimated at EUR 30 to 50 billion.

⁷ Multivariate analyses also demonstrate a statistically significant effect of enterprise size and sector on the likelihood that an SME with international turnover is doing business in the USA.

⁸ As SMEs that export to emerging or developing markets presumably incur high additional costs as well and are more often found among exporters that are also active in the USA, they were not considered in this comparison. This ensures that it is not their operations in emerging and developing markets that drive the perception of additional costs being a burden on SMEs exporting to the USA.

⁹ Mutual recognition of technical norms and standards and of tariff reductions were on the agenda of the TTIP negotiations, which have been put on hold for the time being. See also Abel-Koch, J. and Schneider, J. F. (2016): TTIP – an opportunity for European SMEs, Focus No. 118, KfW Research, Frankfurt am Main.

¹⁰ Cf. Abel-Koch, J. (2016): KfW Competitiveness Indicator 2016 – German SMEs must defend their competitiveness – and continue improving their energy efficiency, KfW Research, Frankfurt am Main.

¹¹ In reality, however, the additional costs of external trade for SMEs are likely to play a bigger role than the numbers shown here suggest, as those SMEs that perceive the additional costs of external trade to be particularly high do not take their business abroad in the first place and thus fall out of the sample.

¹² Cf. Abel-Koch, J. (2016): SMEs' value chains are becoming more international – Europe remains key, Focus No. 137, KfW Research, Frankfurt am Main.