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››› The world is not a village – geographic proximity to export markets is crucial to SMEs

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Open markets are important for many German SMEs. In 2016, internationally active SMEs achieved a turnover of around EUR 547 billion – more than one fourth of their total – outside Germany. Most SMEs focus on only a few target markets within Europe. The most important export countries are Austria and Switzerland, followed by the Benelux states and France. Europe accounted for more than two thirds of SMEs' international turnover, or some EUR 373 billion, in 2016.

There are sharp regional differences. SMEs from Bavaria and Baden-Württemberg export more than average to the southern neighbouring countries while western German SMEs export to the Benelux states and France particularly often. Eastern German SMEs are represented primarily in the Czech Republic, Poland, Slovakia and the Scandinavian countries.

The importance of geographic proximity to the target markets for the export activities of SMEs is also illustrated by the additional costs of exporting. For many SMEs, transport costs are the key reason why selling goods or services abroad is more costly than selling them on the domestic market. Market development costs also play a major role, however. They are particularly relevant for innovative enterprises with new products. The costs of financing or hedging export transactions, on the other hand, are of little significance for most SMEs.

Overall, roughly one in ten euros earned abroad must be spent on market analyses, new sales channels and marketing strategies, necessary product adaptations, goods transport, tariffs and other additional costs – nearly EUR 50 billion in 2016. New bilateral and multilateral free trade agreements that lower tariffs and harmonise standards, as well as investment in infrastructure, could reduce these costs noticeably – and encourage enterprises previously inactive as exporters to take up cross-border operations.

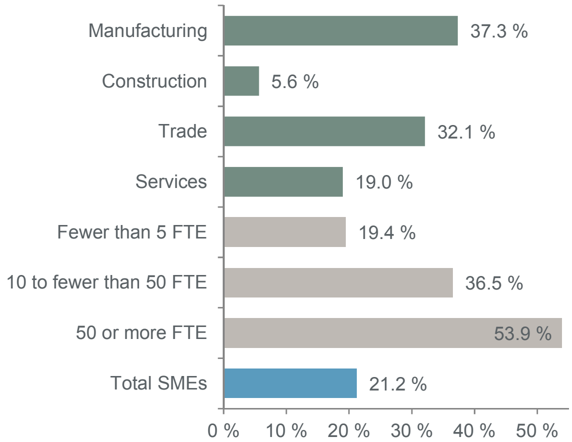
SMEs want trade barriers to be removed

Open borders and free trade are among the key economic policy demands of SMEs' associations on the future German Federal Government. From their point of view, the focus should be on strengthening the European internal market. Barriers to trade with Asia and other high-growth regions should however also be dismantled and fair competition promoted – through multilateral efforts within the World Trade Organisation (WTO) or bilateral free trade agreements.[1]

International business is important for many SMEs

Indeed, international business is important for the success of many German SMEs, as shown by the most recent results of the KfW SME Panel.[2] In 2016, one in five of the approximately 3.6 million SMEs in Germany exported and generated an average 27 % of their total turnover abroad. SMEs achieved foreign turnover of some EUR 547 billion in total – representing around 38 % of Germany's total goods and services exports.[3] Many SMEs are also suppliers for large German corporations which sell a significant share of their products abroad. If we take these indirect exports into account, it is likely that an even greater proportion of German SMEs' turnover depends on foreign markets.[4]

Figure 1: One in five SMEs is active outside Germany

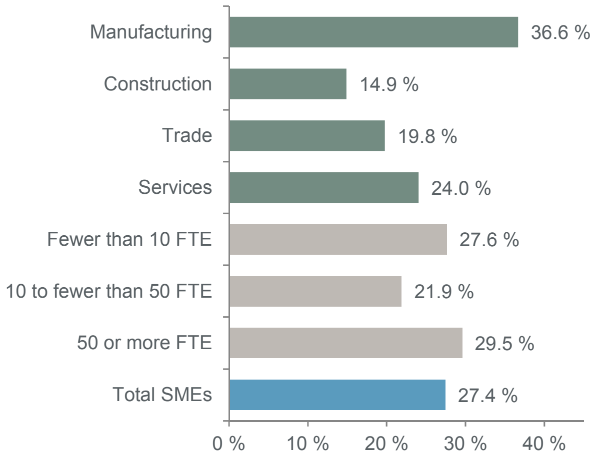


Note: Share of SMEs with international turnover in 2016.

Source: KfW SME Panel 2017

Open markets play an important role particularly for manufacturing SMEs. More than one third of them sell their goods abroad (Figure 1). The share of exports in SMEs' turnover is greater than average in this sector, at nearly 37 % (Figure 2). Overall, manufacturing SMEs generated EUR 277 billion abroad in 2016, more than half of the total international turnover of German SMEs (Figure 3) – even though they represent a mere 7 % of all German SMEs.

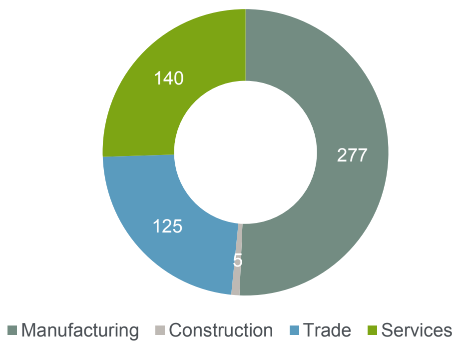
Figure 2: Foreign markets account for one fourth of turnover of small and medium-sized exporters



Note: Share of international turnover in total turnover of SMEs with international business in 2016.

Source: KfW SME Panel 2017

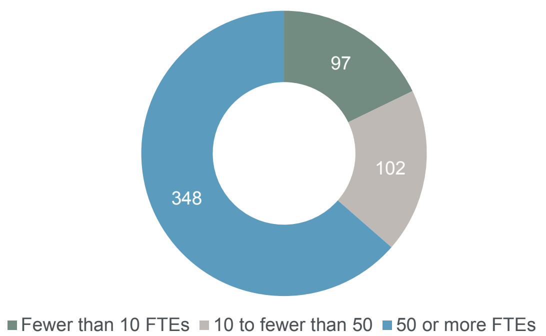
Figure 3: Manufacturing enterprises drive SMEs' international turnover



Note: International turnover of SMEs by sector in EUR billions for 2016.

Source: KfW SME Panel 2017

Figure 4: Large SMEs are disproportionately represented



Note: International turnover of SMEs by size classes on the basis of full-time equivalent employees (FTEs) for the year 2016.

Source: KfW SME Panel 2017

Export orientation is determined not just by the sector but also by the size of a business. While the share of exporters among SMEs with fewer than 10 employees is below 20 %, for SMEs with 50 and more employees it is over 53 % (Figure 1). Last year enterprises with 50 and more employees contributed around two thirds, or EUR 348 billion, to the international turnover of German SMEs (Figure 4) – although they account for less than 2 % of all German SMEs.

Germany's export surplus – driven by SMEs?

For years, Germany has run significant trade surpluses which reached a new record level of EUR 252 billion in 2016. Already in 2014, the European Commission initiated a macroeconomic imbalance procedure against Germany, and the IMF is increasingly critical of the export surpluses as well. The state and private households have contributed comparatively little to the expansion of Germany's current account surplus. By far the greatest share of the growing surplus is due to the enterprise sector.[5]

However, this does not apply to German SMEs. According to Eurostat/OECD data – which are based on a slightly narrower definition of SMEs – businesses with fewer than 250 employees actually run an import surplus regarding trade in goods in 2015. They imported goods worth nearly EUR 261 billion – but exported goods worth only EUR 231 billion, implying an import surplus of some EUR 30 billion for German SMEs. This means that measured by the trade in goods, the most important component of the balance of trade and current account, it is primarily large enterprises with 250 and more employees that drive Germany's surplus.[6]

Europe is of crucial importance

A glance at the target regions shows that Europe is clearly the focus of small and medium-sized exporters. This is where around 95 % of them sell their goods and services (Table 1). In 2016, German SMEs generated a turnover of some EUR 373 billion in Europe – more than two thirds of their total international turnover. Against this backdrop it is not surprising that SMEs' associations consider strengthening the European internal market as one of the most important tasks of economic policy in the coming legislative period.

Particularly important markets for German SMEs are Austria and Switzerland. More than 63 % of small and medium-sized enterprises export to this region. Besides geographical proximity, the common language is probably a key factor that facilitates trade with these countries. After all, from the perspective of SMEs, cultural and language barriers continue to be important obstacles to international operations.[7]

Brexit could hit one in four exporting SMEs

No fewer than one in four exporting SMEs is active in the United Kingdom or Ireland, benefiting from the rules of the European internal market which provide for the free movement of goods and services. In what ways Brexit will affect the trade relations of these SMEs will depend on the trading rules that will be agreed upon between the United Kingdom and the remaining 27 EU states for the time after the United Kingdom leaves the EU. However, the EU does not expect relevant negotiations to begin before December this year.[8]

Table 1: Neighbouring countries are top export destinations

Shares of internationally active SMEs with turnover in ...	
Austria / Switzerland	63 %
Benelux	39 %
France	30 %
Spain / Portugal / Italy	26 %
Czech Republic / Slovakia / Poland	26 %
United Kingdom / Ireland	25 %
Scandinavia	22 %
USA	15 %
Balkan states / Greece	14 %
Asia (without China)	12 %
China	11 %
Turkey	10 %
Russia	11 %
Africa / Middle East	8 %
Baltic states	7 %
Latin America	6 %
Europe	**95 %**
Emerging and developing countries	**27 %**

Note: SMEs that achieved turnover in the respective target region in 2015 as a share of all SMEs with international turnover in 2015. Multiple responses were possible. Europe comprises the target regions Austria / Switzerland, Benelux, France, Spain / Portugal / Italy, Czech Republic / Slovakia / Poland, United Kingdom / Ireland, Scandinavia, Balkan states / Greece, and the Baltic states. Emerging and developing economies comprise the target regions Asia (without China), China, Turkey, Russia, Africa / the Middle East, and Latin America.

Source: KfW SME Panel 2016

USA is most important destination outside Europe

The USA is the most important export market for German SMEs outside Europe. Around 15 % of SME exporters conduct business there (Table 1). Compared with small and medium-sized exporters as a whole, they are particularly high-turnover, internationally oriented and innovative companies. Half of them offer individual products or services tailored to the customer's needs. Their equity ratio is an above-average 38 %.[9]

Many small and medium-sized exporters doing business in the USA are therefore well equipped to deal with increasingly difficult trading conditions, for example. It is true that the USA has not yet imposed the repeatedly threatened punitive tariffs on the automotive industry, nor is there currently any talk of introducing what has been referred to as border tax adjustments. But protectionism has nonetheless increased measurably in the USA. The Centre for Economic Policy Research (CEPR) recorded a 26 % year-on-year increase in discriminatory measures in the first six months of the year.[10]

China is especially relevant for larger SMEs

China in particular has become more important as a trading partner for emerging and developing economies.[11] Its share in German goods exports grew from around 1 % to more than 6 % between 1997 and 2016. Last year alone, German exports to China rose by 6.7 % while German exports overall grew by only 1.1 %. In terms of both exports and imports, China was Germany's most important trading partner last year.[12] It holds a firm position for German SMEs as well. In the category of smaller exporters with fewer than ten employees, one in ten achieves turnover in the People's Republic, and in the group of larger exporters with 50 and more employees it is almost one in three.

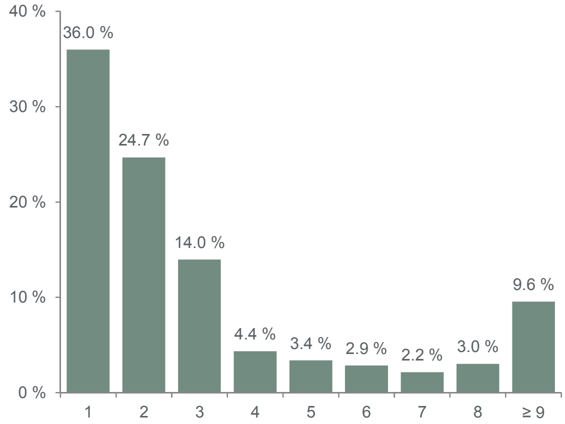
As the world's second biggest economy, China is set to remain an interesting sales and procurement market for German SMEs in the future. Additional impetus for international trade with China could come from what is being referred to as the 'New Silk Road'. Under this project, China intends to build modern infrastructure along historic trade routes in a bid to link its markets more effectively with the European continent. Already there are some freight rail links, for example between Hamburg and Zhengzhou. Moving a container by rail is significantly faster than by sea and much more cost-effective than by air. Although the project is not without controversy, it could result in new export opportunities for some SMEs.[13]

Exporting SMEs are hardly diversified at regional level

Tapping into new markets – whether in Asia or elsewhere – reduces an enterprise's risk of suffering a loss of turnover should one of the target countries be hit by a negative exogenous shock.[14] Greater regional diversification is one of the main reasons why enterprises particularly geared to exports are more likely to survive in the long term.[15]

In the German SME sector, only a small group of exporters benefits from a broad distribution of their target markets. Fewer than 10 % of SMEs with international operations are present in more than eight target regions. By contrast, more than one third of exporting SMEs operate in only a single target region (Figure 5). Regional diversification is mainly a question of company size. On average, small exporters with fewer than ten employees operate in three different target regions, while larger exporters with more than 50 employees operate in more than six.

Figure 5: Most SMEs are active in only a few international markets



Note: Share of SMEs with international turnover in 2015 by number of target regions (as listed in Table 1).

Source: KfW SME Panel 2016

Geographic proximity to export markets is crucial

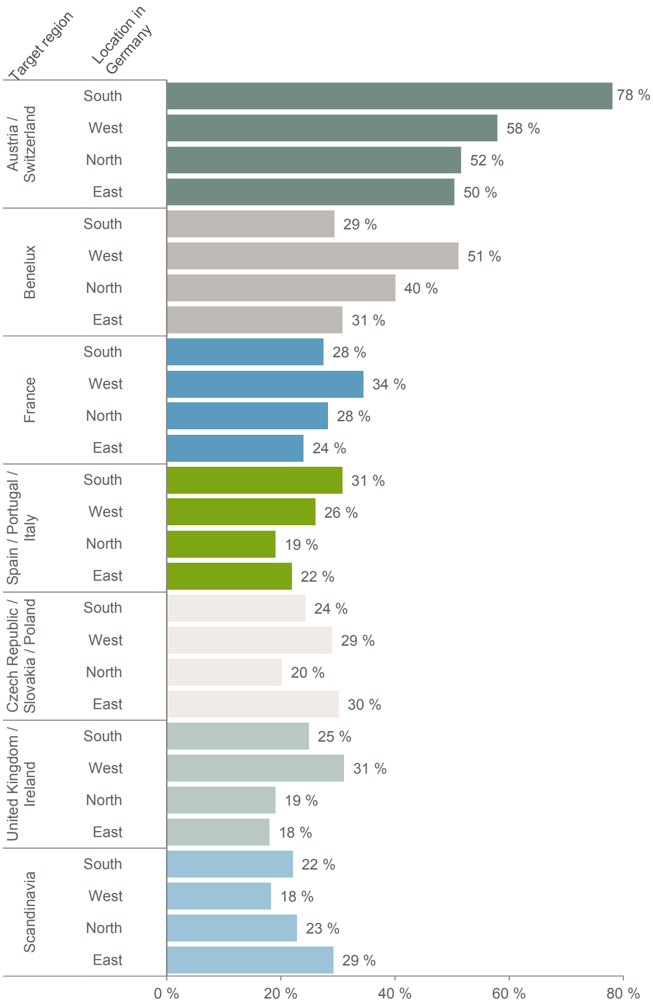
To which target regions an SME exports depends very much on geographic factors. The strong focus of exports on Europe suggests this already, even though other factors are likely to play a role here as well – such as the free movement of goods within the European internal market or uniform standards and norms.

The importance of geographic proximity also becomes clear when comparing exporting SMEs from different regions of Germany. For instance, exporting SMEs from Bavaria and Baden-Württemberg are more often active in Austria and Switzerland than exporting SMEs from other regions in Germany. About 78 % of exporting SMEs from southern Germany are present in the southern neighbouring countries, but only around 50 % of exporting SMEs from northern and eastern Germany (Figure 6).

SMEs from western Germany – North Rhine Westphalia, Hesse, Rhineland Palatinate and the Saarland – frequently export to the Netherlands, Belgium and Luxembourg. The share of exporting SMEs that sell to the Benelux countries is around 51 % in western Germany, a full 20 percentage points higher than in eastern Germany. France, too, is a target market for more western than eastern German SMEs.

Small and medium-sized enterprises from Berlin, Brandenburg, Saxony, Saxony-Anhalt or Thuringia, on the other hand, export relatively often to Poland, the Czech Republic and Slovakia. They are also more present in Scandinavian countries, with which they are connected via the Baltic Sea.

Figure 6: Location of SMEs in Germany influences their choice of export markets in Europe



Note: Share of SMEs with international turnover in 2015 based in Germany's south (Baden-Württemberg, Bavaria) west (Hesse, North Rhine Westphalia, Rhineland Palatinate, Saarland), north (Bremen, Hamburg, Mecklenburg Western Pomerania, Lower Saxony, Schleswig-Holstein) and east (Berlin, Brandenburg, Saxony-Anhalt, Saxony, Thuringia) that achieved international turnover in the relevant target region.

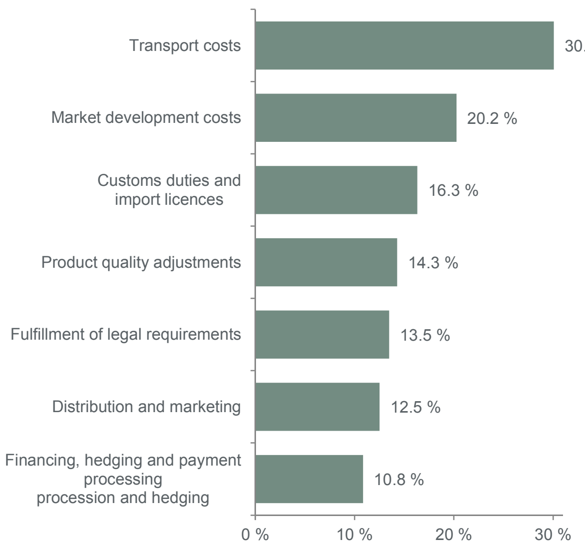
Source: KfW SME Panel 2016

Transport costs are main cost factor in international trade for SMEs

The importance of geographic proximity for SMEs' export activities is also illustrated by the additional cost of international business. From the perspective of SMEs, it is mainly transport costs which make selling goods or services abroad more costly than selling them on the domestic market. Transport costs play a large or very large role in international trade for more than 30 % of exporting SMEs. No other cost factor is perceived as more burdensome (Figure 7).

According to estimates by the United Nations (UNCTAD), transport costs accounted for about 6.8 % of the value of goods in industrial countries' international trade between 2005 and 2014.[16] The level of transport costs depends not only on the physical distance of a country to its export markets but also on the existing infrastructure. Investment in seaports and airports, roads and railways can significantly lower transport costs in international trade.[17] The recent Rhine Valley rail corridor closure has demonstrated how weak infrastructure affects cross-border freight transports. A lack of appropriate alternative routes for the most important north-south corridor linking the seaports of Rotterdam and Genoa has hampered the supply of resources to manufacturers and deliveries to their customers.[18]

Figure 7: Transport costs make exporting more expensive



Note: Share of SMEs with international turnover in 2015 for whose international business the respective cost type plays a large or very large role.

Source: KfW SME Panel 2016

Cost of market development is significant for innovative enterprises

Becoming familiar with the economic, legal and cultural environment in the target country, estimating the market potential, and making contact with possible business partners - developing an international market requires personal and financial effort. The cost associated with market development plays a significant role in international business for one in five SME exporters (Figure 7).

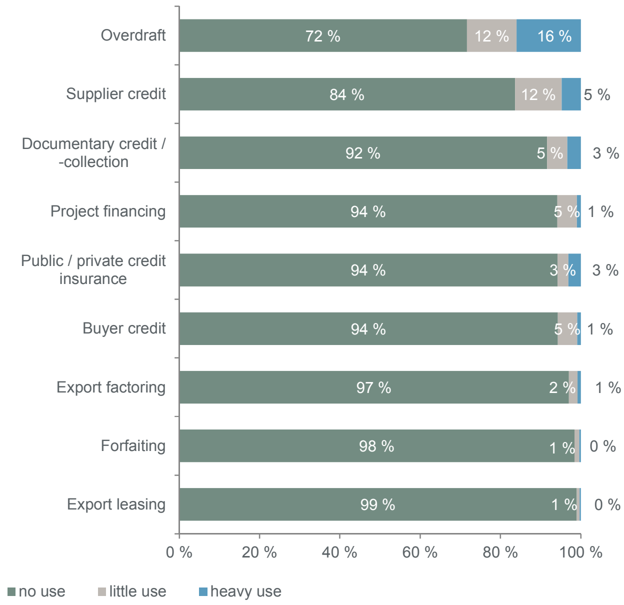
Developing international markets is particularly challenging for innovative enterprises with new products. Market development costs play an important role for 38 % of exporters that introduced a product innovation during the period 2013–2015, but for only 12 % of exporters that did not introduce any product innovation. Nevertheless, the expenditure is worth it, as innovative enterprises on average achieve twice the international turnover of those that do not innovate.[19]

Financing costs play a rather small role

The costs of financing and hedging export transactions or of processing international payments tend to matter little for most SMEs. They play a more important role for only one in ten small or medium-sized exporters. This is consistent with the finding that most of the export financing and insurance schemes are used by only few SMEs (Figure 8).

The only instrument employed more frequently is bank overdrafts. These are not explicitly meant to be used to finance international business but can be drawn relatively fast and easily – a crucial advantage for SMEs with lower export volumes and limited human resources. Supplier loans are used primarily by SMEs that export to the USA. About 17 % of them make heavy use of this instrument – compared with only 5 % across all SME exporters. Documentary letters of credit are used even more rarely – by only 3 % of SME exporters. They are attractive mostly for SMEs that export to emerging and developing market economies. Almost one in ten of them make heavy use of this insurance instrument.

Figure 8: Only few SMEs use special instruments to finance and hedge exports



Note: Share of SMEs with international turnover in 2015 that make no, little or heavy use of the relevant instrument to finance or hedge their exports.

Source: KfW SME Panel 2016

Additional costs are one tenth of international turnover

For SMEs, the additional cost of exporting – compared with production and sales within Germany – can be estimated at around 10 % of international turnover. In 2016 exporting SMEs thus spent nearly EUR 50 million on developing and cultivating their international markets. That includes the costs of market analyses, product adaptations and development of an international distribution network as well as transport and financing costs. It does not include the cost of production, which they would also incur when selling on their domestic market.

The additional costs do not make up the same share of international turnover for all SME exporters. Multivariate analyses show that the share of additional costs in international turnover increases as international turnover grows. In order to achieve higher international turnover, enterprises also need to develop more distant and less readily accessible target markets – such as the USA or China. This often involves significantly higher additional costs. Enterprises wanting to reach beyond European boundaries must factor in a higher share of their international turnover to pay for shipping and tariffs alone than enterprises that do business only in the European internal market.

Having own international production or distribution sites abroad is also of relevance. The share of additional costs in international turnover is significantly higher if the enterprise has invested outside Germany in the previous years. While a new production or distribution site leads to higher international turnover in the long term, such an investment increases the cost of international business in the short term.

Not least, the share of additional costs in international turnover depends on the size of the enterprise. It decreases with the number of employees. This indicates that efficient management of international business requires human resources which small enterprises often do not possess.

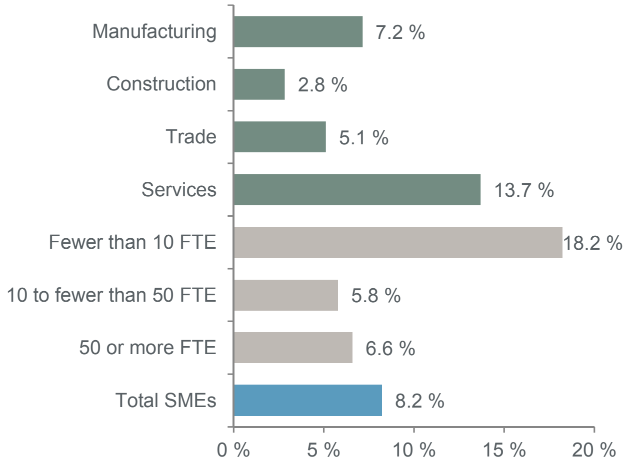
Exports will continue to be a mainstay for SMEs

Germany's positive economic development is being driven primarily by strong domestic demand. Nonetheless, exports will likely remain an important success factor for German SMEs in the future as well. About one in three exporting SMEs expect their international turnover to grow between 2017 and 2019 while half of them expect no change. Only few businesses expect a decline and even fewer plan to withdraw from international business altogether.

Overall, German exporting SMEs expect their international turnover to rise moderately by around 8 % between 2017 and 2019. This rate of growth is also bolstered by predictions of further economic recovery in Europe – the main target region of small and medium-sized exporters. Brexit is likely to pose the main risk to this outlook.[20] But growing protectionism in the USA and a weakening business cycle in emerging economies could also have an adverse effect on exports for some SMEs.

SMEs in the services sector are particularly optimistic. They expect their international turnover to grow by nearly 14 %, but they are also starting on a significantly lower level than SMEs in the manufacturing sector. A moderate absolute increase will also have a relatively strong impact on small exporters with fewer than ten employees, which expect their international turnover to grow by 18 % on average between 2017 and 2019.

Figure 9: SMEs expect moderate growth of international turnover



Note: Expected growth in international turnover in the three-year period of 2017–2019 of all SMEs that achieved international turnover in 2015. Weighted with the volume of international turnover.

Source: KfW SME Panel 2016

Conclusion

Many German SMEs are exporters. However, developing and cultivating international markets comes at a cost, requiring them to spend one in ten euros earned abroad on market analyses, new sales channels and marketing strategies, necessary product adaptations, goods transport, tariffs and other additional costs. In 2016 these costs amounted to nearly EUR 50 billion.

The additional cost of doing international business could be reduced significantly, for example through bilateral or multilateral trade agreements that lower tariffs and harmonise standards.

Investment in infrastructure, both in Germany and in the target countries, could lead to significant reductions in transport costs, which still make up a major portion of the cost of international trade. It is estimated that, all else equal, the road link between two cities in Europe is around 10 % longer when both cities are located not in one country but in different countries. Investment in road links that eliminate this disadvantage could raise trade between different European countries by more than 15 %.[21]

Ultimately, adapting the financing and hedging instruments to the needs of small and medium-sized exporters could also contribute to lowering the costs and risks of international business. For one thing, the bureaucracy involved in using financing and hedging instruments would have to be reduced. For another, some SME exporters see an insufficient offer of export finance for smaller volumes.[22]

Reducing costs in international trade could strengthen not just the SMEs that already operate abroad. It could also encourage previously inactive enterprises to start doing business across borders – with positive effects on growth and employment.[23] ■

[1] Cf. Arbeitsgemeinschaft Mittelstand (2017): Der Mittelstand – Erwartungen zur Bundestagswahl 2017 (*The Mittelstand – expectations on the 2017 parliamentary election*) and German Association for Small and Medium-sized Businesses (2017): Unternehmerprogramm des Mittelstands zur Bundestagswahl 2017 (*Entrepreneurship programme of the Mittelstand for the 2017 parliamentary election*); our title translations, in German.

[2] Each year the KfW SME Panel surveys up to 15,000 representative private enterprises of all sectors with an annual turnover of up to EUR 500 million. For more information see Schwartz, M. (2016): KfW SME Panel 2016 – Businesses are using their financial strength, but not boosting investment, KfW Research.

[3] See German Federal Statistical Office and Deutsche Bundesbank (2017): Außenhandel und Dienstleistungen der Bundesrepublik Deutschland mit dem Ausland (*Cross-border trade in goods and services of the Federal Republic of Germany* – our title translation, in German).

[4] Cf. Abel-Koch, J. (2017): SMEs' value chains are becoming more international – Europe remains key, Focus on Economics no. 137, KfW Research.

[5] See also Borger, K. (2017): Current account balance: reduce surplus, make Germany stronger, Focus on Economics no. 178, KfW Research.

[6] Cf. Eurostat/OECD Trade by Enterprise Characteristics (TEC) Database.

[7] Cf. Abel-Koch, J. (2017): SMEs' value chains are becoming more international – Europe remains key, Focus on Economics no. 137, KfW Research.

[8] Cf. Tagesspiegel of 17 August 2017: EU: Londoner Vorschläge zu Brexit-Verhandlungen sind "enttäuschend" (*EU: London's proposals on Brexit negotiations are 'disappointing'* – our title translation, in German)

[9] Abel-Koch, J. (2017): SMEs exporting to the USA: innovative high performers, Focus on Economics no. 170, KfW Research.

[10] These include, for example, tax cuts for the US agricultural industry, financial support from the state for specific US enterprises, or requirements to give preference to US companies in public tenders. See Evenett, S. J. and Fritz, J. (2017): Will awe trump rules? The 21st Global Trade Alert Project, London as well as www.globaltradealert.org.

[11] See also, for example, Ulrich, K. (2017): Emerging markets have become more important for Germany's foreign trade, Economics in Brief no. 141, KfW Research.

[12] Based on data from the German Federal Statistical Office on Germany's trade in goods.

[13] See Nicolai, B. (2017): So macht China die Europäer noch abhängiger von sich (*How China is making Europe even more dependent on it* – our title translation, in German), Die Welt edition of 16 January 2017, and Germany Trade and Invest (2016): China investiert massiv in Neue Seidenstraße *(China is investing massively in the New Silk Road* – our title translation, in German) and Garcia Herrero, A. and X. Jianwei (2016): China's belt and road initiative: Can Europe expect trade gains? Bruegel Working Paper Issue 5.

[14] An exogenous shock is defined as a one-off event whose extent and time of occurrence cannot be anticipated by the economic actors. Examples of exogenous shocks are natural disasters, an unexpected change in a central bank's monetary policy, or a technological innovation.

[15] For a discussion of this argument and a summary of the relevant empirical literature see also Wagner, J. (2011): Exports, imports and firm survival: first evidence for manufacturing enterprises in Germany, IZA Discussion Paper 5924.

[16] See UNCTAD (2015): Review of maritime transport 2015. The estimate mentioned here includes all transport routes.

[17] Cf. Behar, A. and A.-J. Venables (2010): Transport costs and international trade, Handbook of Transport Economics, and the studies quoted therein.

[18] Cf. Jehle, S. (2017): Der Ausbau lahmt schon seit Jahrzehnten (*Expansion is not progressing since decades* – our title translation, in German), Stuttgarter Nachrichten edition of 29 August 2017, and Verband der chemischen Industrie e. V. (2017): Hälfte der Chemietransporte muss verlagert werden (*Half of chemical transports must be redirected* – our title translation, in German), press release of 25 August 2017.

[19] The empirical literature also presents strong evidence of a positive correlation between enterprises' innovation activity and export success. For a summary of relevant studies, see Love, J. H. and S. Roper (2015): SME innovation, exporting and growth: a review of existing evidence, International Small Business Journal 33(1), p. 28–48.

[20] Cf. Borger, K. (2017): KfW Business Cycle Compass Germany August 2017. Germany's real growth in 2017 and 2018: heading for two per cent, KfW Research.

[21] Cf. Braconier, H. and M. Pisu (2013): Road connectivity and the border effect: evidence from Europe, OECD Economics Department Working Papers, No. 1073, OECD Publishing, Paris.

[22] See also Wocher, M. (2017): Kein Geld für Exporteure (*No money for exporters* – our title translation, in German), Handelsblatt edition of 25 August 2017, p. 20–21.

[23] See also Love, J. H. and S. Roper (2015): loc. cit. and Zimmermann, V. (2017): Success factors of high-growth enterprises, Focus on Economics no. 177, KfW Research.