Executive summary

Latin America will have relatively strong growth in the short term, and if necessary there is room for countercyclical action. However, the picture for the medium term is more complex. A decline in external demand will expose the limitations of the current growth pattern, which is based on low added value and on exports of natural resources in many countries in the region. Latin American governments must act now, in line with their short-term macroeconomic policies, to strengthen productive structures and overcome the problems of structural heterogeneity through diversification and development. Latin American small and medium-sized enterprises (SMEs) can become catalysts for this structural change and productivity growth. An effort of this nature requires a new approach to public policies for SMEs. For these policies to be effective, there must be greater coherence and co-ordination among infrastructure policies, the provision of services, and sectoral policies. In particular, policies in the areas of finance, skills and training, systems for innovation and the dissemination of technology, and productive linkage policies can help SMEs overcome their obstacles. Policies must be designed in a way that takes into consideration the specificities of sectors, institutions and regions. They must also consider the heterogeneity of all SMEs, since different firms have very different development needs and potential. Many of these tasks require institutions that are able to lead complex processes while being flexible to adapt to the changing requirements of the productive sector.

The economic outlook for Latin America remains relatively positive, but is subject to uncertainty and volatility because of the wider external context.

After nearly a decade of continuous expansion, interrupted only in 2009, the most recent projections indicate growth of 3.2% in 2012 and 4.0% in 2013. These figures indicate an economic slowdown relative to recent performance, which would be accompanied by a decline in inflation. In the short term, this scenario would mean the economy is likely to perform well compared to the rest of the world, providing continued economic stability in the region. In the global economy, sluggish growth is expected in 2012 and 2013 due to fiscal problems, financial fragility and high unemployment in the euro area. Additionally, although the US economy is seeing higher growth than the euro area, economic consolidation is still weak and there remains a risk of a sharp contraction in fiscal strength in 2013. In addition to the slow growth of developed countries there will be a slight slowdown in the Chinese and Indian economies, which have been key drivers of global growth, especially in Latin America.

In the short term, trade will be hit hardest, but if necessary there is room for fiscal and monetary policies to soften the blow.

The impact will vary from country to country, depending on how diversified its export products and destinations are and the size and dynamism of the domestic market. In turn, a decline in international prices of certain raw materials would affect many countries in the region that export such materials, with their trade balance deteriorating and fiscal revenue dropping, although it would provide relief for net importers of food and fuel, especially Central American and Caribbean countries. While there is risk that a reversal in capital inflows might hurt the financial sector, the region has substantially increased its international reserves, which account for around 16% of gross domestic product (GDP) on average. Many Latin American countries have relatively low external debt, their debt is relatively low risk (short-term external debt made up around 15% of the region's total debt) and they have good access to contingent lines of international liquidity. These factors should allow most countries to prevent a contraction in external financing from contributing to an economic downturn. Moreover, good macroeconomic performance and prudent management of macroeconomic policies in recent years have put the region in a strong position. For instance, if aggregate demand falls there is scope for fiscal stimulus thanks to relatively low government debt (39% of GDP on average) and generally well-balanced budgets (-1.8% of GDP on average). Also, in terms of monetary policy, inflation forecasts remain well grounded and the risks of overheating appear to be under control, thanks in particular to macroprudential and regulatory measures adopted by various countries in recent years. Therefore, there is scope for introducing an expansive policy if the external situation makes it necessary.

However, there are significant macroeconomic challenges that could affect economic growth in the medium term and sustain trends of low productivity, scant diversification of production and persistent structural heterogeneity.

There is great uncertainty regarding the next few years, as OECD countries deal with structural problems, since the institutional reforms and changes required are huge in many cases and will take a long time to implement. This uncertainty combined with the low interest rates that are expected in more advanced economies could cause highly volatile capital flows and raw-material prices, possibly causing exchange-rate fluctuations. This could damage the competitiveness of certain tradeable-goods sectors in the region, hinder the diversification of production and condition the capacity for future growth. Higher capital inflows in the region, as has already been observed in recent years, could lead to unsustainable rises in the prices of certain assets or excessive credit expansion, causing macroeconomic imbalances that would significantly limit economic growth. Falling raw-material prices following the slowdown in Asian growth and the change in its composition could shrink the macroeconomic space available to finance measures to address structural weaknesses in the Latin American economies. This could, for example, happen through investment in infrastructure, which could increase the competitiveness of tradeable-goods sectors. Such a scenario would expose the limitations of Latin America's production structure and the current growth pattern, which in many countries in the region is based on exports of natural resources.

Therefore, coherence must be ensured between short-term stability-oriented policies and structural measures to enhance potential growth.

Greater regional integration is an effective response to sluggish growth in demand from developed countries. Better integration would also enable the region to develop dynamic competitive advantages in non-traditional sectors and activities and increase the diversification of its exports. Economic policy has various tools to protect against the risks of currency appreciation and volatile prices of raw materials. Depending on the causes and nature of the currency appreciations, these tools, which include exchange-rate interventions, macroprudential regulations and fiscal policy, can make the rest of the tradeable-goods sector more competitive. Investment could be channelled into infrastructure, innovation and human capital, which would help transform and diversify production. Institutions and fiscal instruments such as stabilisation funds and fiscal rules can be useful for stemming currency fluctuations and creating sustainable fiscal space for additional investment.

A more integrated approach to public policy to empower SMEs as agents of structural change

SMEs have a key role to play in enhancing Latin America's potential growth. But SMEs are highly heterogeneous in terms of access to markets, technologies and human capital, as well as their linkages with other firms, and these factors affect their productivity, export capacity and potential growth.

On the one hand, SMEs are a fundamental building-block of the productive structure, accounting for around 99% of businesses and employing around 67% of employees. But on the other hand, they contribute relatively little to GDP, which reflects their low levels of productivity. For instance, large companies in the region reach levels of productivity which are as much as 33 times greater than those of microenterprises (*vs.* 2.4 times in OECD countries) and are up to 6 times more productive than small firms (*vs.* 1.6 times in OECD countries). Furthermore, levels of internationalisation for SMEs in Latin America are significantly lower than in Europe and East Asia. For instance, while only around 10% of Latin American SMEs engage in export activities, 40% of European SMEs do so. Within this productive context, well-designed co-ordination policies are essential to ensuring that production is diversified, which is one of the region's major structural challenges. Latin American SMEs are highly heterogeneous, ranging from sole traders running informal microenterprises to highly efficient innovative companies with the capacity to export products. If a set of coherent, co-ordinated policies is introduced, SMEs could contribute to structural change by helping to improve productivity, complementing the economies of scale of large firms fostering the creation of production clusters (and contributing to social inclusion).

Public policies should support the development of SMEs in order to close the gaps with larger enterprises, with the objective of supporting SMEs as catalysts of structural change.

To accomplish this, SME policies should consider six relevant dimensions:

1) First, in addition to their small size, a frequent problem SMEs confront is their inability to achieve economies of scale or the necessary specialisation. Because these firms are isolated, policies are often more effective when: *a)* they focus on the full production cluster or value chain into which SMEs are integrated; *b)* the policy intervention is adjusted to the type of company, taking into account its different policy needs; differentiating, for instance, between microenterprises operating in the local market and an incipient cluster of competitive companies that exports products. There are no blanket solutions, and interventions must be specifically adapted to the production chain, cluster or region.

2) Second, given the significant interactions and complementarities among policies, a high level of co-ordination is needed among sectoral policies, including infrastructure policy and the provision of services to remove the bottlenecks affecting the productive development of SMEs and their sphere of influence. Furthermore, it is of critical importance to facilitate the integration of these policies into other overarching policy areas such as industrial policy and innovation policy, as well as the national development strategy.

3) Third, in addition to these improvements to horizontal co-ordination, greater vertical co-ordination is also necessary given the role that local and regional actors play in policies that support production clusters and chains at the sub-national level. For example, instruments should be operated in a decentralised manner to ensure they reach the intended beneficiaries throughout the country.

4) Fourth, given the long maturation period, policies must have specific objectives that are sustained over time. More than being intensive in financial resources, these policies must provide specific inputs and services with monitoring and assessment mechanisms so they can be tweaked and fine-tuned accordingly. For instance, co-ordination policy initiatives should be accompanied by a business plan with a clear timeframe. Such a plan requires a regulatory framework, including a monitoring system, a set of regulations and a favourable macroeconomic environment.

5) Fifth, better co-ordination is needed among economic actors. With financial restrictions limiting the scope of public policy and a need for investment that is often beyond the capacities of individual companies, incorporating associative actions into programmes for SMEs provides an opportunity to reduce transaction costs. The fixed cost of support activities will thus be shared among a larger number of beneficiaries, boosting efficiency and coverage. Creating opportunities for co-operation among firms stimulates competitive advantages and externalities that will help consolidate and drive forward business modernisation. The main objectives of these partnership programmes to support SMEs are: *a)* to distribute information on markets and technologies; *b)* to adopt new techniques and technologies; *c)* to find and develop processes for the exchange and complementing of resources, knowledge and skills; *d)* to build up trust so actors will come together and engage in dialogue.

6) Finally, the integration of production clusters into global value chains (GVCs) presents opportunities for SMEs. The global production structure has moved towards internationally integrated production systems. This segmentation of the

production process can provide SMEs in the region with new opportunities to access new markets, especially those firms that operate in small domestic markets. The integration of clusters and business networks into GVCs can help SMEs diversify exports, create new jobs and acquire new technological capacities in accordance with international best practices, thereby strengthening competitiveness. However, this integration into GVCs also presents challenges. The distributional effects and spillovers to domestic economies are not automatically guaranteed. Whether SMEs seek to improve their product, production process or function in the chain depends on several factors such as governance of the chain and the specific characteristics of the sector. Despite the challenges these strategies present, governments, non-governmental organisations (NGOs) and transnational enterprises in the region are expanding their activities and programmes to support the inclusion of the region's SMEs in GVCs through various policies, such as supplier development programmes, better access to information on external markets and existing chains in the country, as well as training programmes within universities and businesses to provide specific skills required at different stages of the production within these chains.

The above considerations combine elements of industrial policy and regional development policy and define the main characteristics of an SME policy; however, there are also synergies with other policy areas.

Three areas of intervention are particularly useful for removing bottlenecks for the development of SMEs in Latin America:

- access to finance
- innovation and technology policies, especially access to information and communication technologies (ICTs)
- the development of skills and human capital

Reducing the financing gap for SMEs: new instruments and public policy

Access to finance is one of the principal barriers limiting the development of SMEs.

SMEs in the region receive only 12% of the total credit in the region, while in OECD countries SMEs are the recipients of 25% of total credit. One-third of small businesses in Latin America identify access to finance as a serious restriction. Long-term financing is also more expensive for SMEs, with high interest rates when compared to large enterprises, sometimes doubling the capital costs faced by the latter. This difference in cost is due in part to the transition of the region's banking sector from a relational scheme into multi-service banks. The transition of the banking sector has led to a fall in net interest margins in Latin America to 8.6%, which is still considerably higher than the OECD area's figure of 2.7%, revealing problems in the region's financial structure and level of competition. While few small Latin American enterprises receive financing, the level of approval for loans to SMEs is relatively high (around 80% of applications in Brazil and Argentina are successful, for example). In short, the lack of financing in the region is not only a problem of insufficient supply or the availability of resources, but it also includes issues related to demand and self-exclusion. Other elements, including the ongoing asymmetry of information between the financial sector and SMEs, as well as the lack of collateral, show that new instruments are needed to provide innovative solutions to businesses' requirements according to their sector of activity, stage of development or strategic potential.

In order to fill the gap in long-term financing provided by commercial banks, public financial institutions (PFI) are increasing their support to SMEs through various instruments, such as the provision of guarantees, long-term credit lines and other instruments adapted to the needs of SMEs.

The participation of PFIs in Latin American banking systems is considerable, amounting to 23% of the loan portfolio in 2009 to the tune of USD 600 billion thanks to sustained annual growth of 15% in the 2000s. Furthermore, this has led to increased coverage by national guarantee systems. An interesting development is the growing supply of financial services provided by development banks that, beyond loans and guarantees, include products such as credit cards, electronic transaction systems and factoring. These services provide specific benefits to SMEs, in particular for those companies integrated with GVCs, by promoting increased liquidity, improving cash flow and reducing the risk of default. To facilitate the creation of new enterprises and improve access to credit for nascent businesses that encounter financing difficulties due to their lack of credit history, governments in the region have designed specific initiatives for the distinct stages of a business's development (incubation, initiation, growth and consolidation). Programmes such as Financiadora de Estudios y Proyectos (FINEP) in Brazil, the entrepreneur programme Nacional Financiera (NAFIN) in Mexico, and the business angels network from Corporación de Fomento de la Producción (CORFO) in Chile combine different technical support instruments and actors (incubators, seed capital, angel investors and risk capital) in search of new ways to promote long-term investment.

Enhancing SME competitiveness through the incorporation of knowledge and the use of new technologies

Within the innovative sphere, SMEs encounter significant barriers and demonstrate poor growth, which is aggravated by barriers in other areas.

In part this is due to the smaller size and lesser possibility of the productive use of technology. Given the high risks associated with innovative activities, SMEs need to associate and link more with other companies in order to innovate. In addition, other factors exist that block the innovative work of firms in Latin America, relating to the difficulties of credit access and the shortage of qualified personnel. For their part, Latin American companies have few linkages with the respective agents of national innovation systems, which illustrates the importance of co-ordinating different sectoral policies to boost SMEs' systemic innovation capacity. There exist several challenges in designing public policies that foster innovation and the introduction of technology in the region, particularly in the areas of: infrastructure; investment in basic laboratories; human resources training to exploit new technology; and the establishment of specific programmes to promote business innovation in the SME segment.

More intensive use of ICTs can help SMEs augment their competitiveness, lower the costs of entering international markets and improve management.

However, while access to basic ICT technology such as fixed and mobile telephones is at similar levels for SMEs and large enterprises in Latin America, there persist significant gaps between more advanced technologies, such as possessing websites or an intranet. For example, in Argentina 49% of small businesses have a website, in comparison to 83% of large enterprises. These gaps are even larger in Brazil, Chile and Colombia. Broadband access is critical to facilitate the efficient and productive use of ICTs, but the penetration of fixed broadband access in the region is far below that of more developed nations. Therefore, there is significant room for creating policies aimed at improving broadband infrastructure, accessibility and the quality of service. Although most countries in the region have a digital agenda within their technology diffusion policies, only 11 countries in the region include a component of ICTs in their productive sectors.

Improving skills in the workforce and the connection between the education system and the productive sector

The region's lag in education and skills represents one of the major challenges that SMEs are faced with.

Low levels of training among the workforce and managers, the problems associated with the school dropout rate and the poor results achieved in the area of quality, as reflected in PISA (Programme for International Student Assessment) assessments, constitute a major barrier to the development and improved productivity of SMEs Additionally, in this region there are big differences between the skills required by the production sector and the training provided by the education system. Indeed, almost 37% of companies in the region believe finding a workforce with the necessary training is one of their main obstacles, a figure that is higher than the global average and the average for other developing regions.

The difficulty in finding an adequately trained workforce affects SMEs in different ways, due to their heterogeneity and the specificity of required skills.

The "skills gap" has a major impact on SMEs. How difficult it is to find the required workforce depends on several factors, including technological complexity, insertion into GVCs or export orientation. The type of capacities demanded by the SMEs in the region can be arranged in two groups: technical skills, which are closely linked to technological subjects and jobs in the new economy; and non-cognitive "soft skills", where the region's entrepreneurs face more deficiencies. These "soft skills" include aspects such as critical thinking, teamwork, problem-solving and change management, oral and written communication, responsibility at work, or the capacity to adapt to new environments.

To overcome these limitations, better co-ordination is needed between the education system and the productive sector.

Training deficiencies in the region pose a great challenge to SMEs, limiting their development and preventing productivity gains. Public policies are needed to help overcome these barriers.

1) First, one of the main recommendations for public policy must be to develop and strengthen the connection between the education system, especially in technical and vocational training, and the productive sector. This requires smooth dialogue between entrepreneurs, workers and instructors to develop mechanisms so that qualification needs can be defined jointly and the skills demanded by the job market can be anticipated. Brazil's existing vocational training system is an excellent example of this type of strategy, though there are other examples in the region. Furthermore, countries in the region should promote training paths that combine classroom and workplace training which continue over the course of a worker's adult life – much like the successful German dual-model system.

2) Second, the syllabus for technical and vocational training must be broadened and strengthened. Certain skills need bolstering, especially "soft skills" – including generic, cross-cutting skills – in the curriculum, since these skills will enable workers to be effectively integrated into employment. Moreover, these skills allow workers to adapt to the changing demands of the job market and to work in a professional environment in which technology is increasingly being used. Also it is important to bolster the professionalisation of management and senior executives in SMEs by focusing more on training for this sector.

3) Finally, it is necessary to establish or strengthen the institutional structure, which provides incentives for SMEs to provide in-house training for their staff in conjunction with external training programmes. Reference frameworks are needed to better define and compare qualifications and accreditation systems for the recognition of practical training. SME networks are therefore needed to spark synergies and exploit economies of scale, develop tax incentives for training and increase the use of ICTs in training programmes.

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