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## **BREAKFAST MEETING ON FOREIGN DIRECT INVESTMENT:**

### **CAN SME's BENEFITS FROM FDI's**

#### **TOPIC: CHALLENGES FACING SME'S**

**28 November 2004**

On behalf of the Namibia Economic Society, allow me to inform you that it is indeed our honour and pleasure to be associated as a co-publisher on this vital and important topic "*Foreign Direct Investment – Benefits for SME*". We are also further encouraged by the timely inception of this event that focuses on the vital important question as to whether SME's can benefit from FDI's.

The importance of SME and its relation to FDI can be considered broad and there are many various aspects one can present and ponder on this very important question. My presentation however focuses on the challenges faced by SME's and strategies to overcome them. The articulation of such challenges from a practical insight is necessary to understand the participation of the Namibia SME's in the domestic and global trade

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systems. With the advent of formalization and implementation of black economic empowerment (BEE) in the country and the impending impact of the globalization, it is equally necessary to bring out the challenges that Namibia needs to consider as well as perhaps look at other countries success stories such as Japan, Malaysia, which have strong SME sectors which continue to attract FDI at a global level.

But before I addressed the challenges, why do we need to focus on SME's. Mr. Moderator, I do not need to say more except that SME's are borne out of eradicating poverty. The global players through the agenda of Millennium Development Goals (MDG) have realised increasingly that Small and Medium size Enterprises (SMEs) development is the invaluable key to reduce poverty by accelerating economic growth, and promoting and empowering the poor, women and the differently abled so that they can escape malnutrition, hunger, and diseases. But above all that they become economic agents partaking into the mainstream of the economy. Indeed the purpose of SME in terms of poverty reduction is manifold.

First, SME's are considered the nucleus of creating new business in any flourishing economy. A recent survey of OECD countries<sup>2</sup> showed that SMEs account for a large share of the private sector economy representing between 96 and 99 per cent of the total number of enterprises in these economies. Data for developed economies such as Japan and emerging economies such as Malaysia, Philippines, Brazil and India shows that a substantial percentage of above 60% of all companies in those economies are SMEs. It is understood where there are new business, there are self

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<sup>2</sup> See OECD Small and Medium Enterprise Outlook (2002)

employed and empowered economic agents partaking into mainstream on their own account and not perishing on the economic periphery.

Where there are businesses, there must also be output that ensures self reliance. Hence, SMEs because of its proliferation nature can enhance competition and entrepreneurship, and hence have spill over effects on innovation, efficiency and productivity growth that translate into increased value added output. Research therefore reveals that SMEs account for a significant share of output in the above mentioned countries. You will be surprised that in the United States for instance, they account for about 40 per cent of total economic activity and in OECD and emerging economies, about 17 and 20 per cent of its manufacturing output.

SMEs also make an important contribution to overall employment, accounting for 60-70 per cent of the manufacturing total in most developed and fast developing economies. This is because the expansion of SMEs could boost employment more effectively than large firms because they are more labour intensive.

Back home, the government of Namibia recognised the vital role which SMEs can play in the country's socio-economic development as indicated in NDP2 and Vision 2030 that should aid in the eradication of poverty and inequality, two main problems that the country inherited at independence and still is far from solving.

Realising the role that SMEs could play in bridging this gap, government produced a policy paper on SME in 1997 entitled "*Namibia: Policy and Programme on Small Business Development*". This policy document, amongst others stipulates government programmes in place to ensure that

conditions are favourable for SMEs in Namibia to flourish. According to a recent survey conducted by the Namibian Economic Policy Research Unit (NEPRU, 2003) on SMEs, it is evident that this sector is a key sector in poverty alleviation and economic growth generation in Namibia.

The study showed that the sector has exceeded the targets set in NDP2. In terms of the sector's contribution to GDP, it increased from 8.0 per cent as recorded in 2002 to 11.0 per cent in 2003, exceeding the target of 5 to 10 per cent by 2006. In terms of the sector's share in the labour force working full-time, its contribution increased by 4.8 per cent to 19.8 per cent in 2003. As it is in the case of the sector's contribution to GDP, SMEs share in total labour force exceeded the set target of 2.8 per cent annual growth rate in NDP2. The sector's contribution in terms of employment and economic growth is expected to grow further as its contribution to investment increased from 5.1 per cent to 8.5 per cent in 2003. Generally, an increase in investment is followed by more employment creation and growth.

Giving such a policy environment, what are the key challenges that SME can potentially face to develop as a viable economic entity.

The first challenge that other countries faced in terms of SME development and which is evident in Namibia is the high cost of doing business in the face of globalization. There is no basis to prove whether wages in most labour intensive sectors of SME's in Namibia, such as construction, maintenance, carpentry, metal and mechanic is high compared to other emerging economies such as Malaysia and/or India. Anecdotal evidence shows that they probably do and hence could act as a disincentive for FDI to flow into Namibia. This could even be more factual coupled with the slow effort of raising transparency, bureaucracy and red tape as regards to SME

regulation, transactions, and registration in Namibia. All of these are meant to increase the cost of business in the country.

Another challenge is the artificial level of price increases in some of the products and services that SME can take advantage of but cant due to regulatory constraints. One area that comes to mind is the area of health. There was recently an effort of bringing down the cost of medicines by up to 65% for example by introducing generic products. This can serve as a ideal opportunity that SME's can take advantage of by opening up their pharmacies and buying products through a less complicated distribution channel with affordable prices to take advantage of the generic brand medicine market. Instead, excessive regulatory requirements in the pharmaceutical industry prohibit such a move to be put into action.

Worldwide, small business faces more constraints at start up developmental phases. In Africa, for example the failure rate is 85% out of a 100 companies. I am afraid to say that the case of Namibia is no exception. The structural rigidity and the dualistic nature of the Namibian economy aid in the SMEs not fully being supported at their developmental stages. The wealth generation in Namibia is still unlock and concentrated in sectors which do not have backward and forward linkages to the rest of the economy. With entrenched competition from South Africa, SME's in Namibia finds it increasingly difficult to get into the mainstream of the economy.

Another aspect that we all know of is still the issue of access to capital and therefore limited access to technologies. I am putting these two issues together since I believe that another way of saying limited access to capital is once you have capital, then you get access to the technologies you need, and capital clearly has to do with financing. In the context of Namibia, small

business capital requirement can mainly be financed through internal generation. This is in contrast to emerging and developed economies where their reliance is increasingly becoming external rather than domestic. Historically, banks in Namibia were averse to lending to SME's. But the government has seen fit to address financing problems to SME's and cooperated through a credit guarantee scheme in order to encourage the commercial banks to lend more to such businesses. The establishment of the Development Bank of Namibia has recently availed a window facility to address these challenges which is indeed commendable.

The Bank of Namibia, through its research has tackled the issue of private equity and the contributions they could make to the growth of SMEs. Among others the paper concluded that private equity as a source of alternative finance for SMEs in Namibia could go a long way in removing the constraints posed especially by start up capital for SMEs. The paper accordingly recommended, among others, that Venture capital should be encouraged as one of the sources to finance SMEs in Namibia. In addition to providing finance, Venture capital also assists with the provision of expertise necessary for the success of these businesses at the initial stages. Specifically, the paper recommended that private-public partnership be encouraged particularly for investments in start-up businesses. This initiative will stimulate the growth of the SME sector, reduce the backlog of unemployment and thus promote the attainment of the goals of poverty and income inequality reduction in the economy.

Coupled with financing problems is the issue of technology. The problem we are still confronted with today in terms of technological innovation is the low level of productivity of both the capital and labour. For capital, most

capital is sourced from South Africa which is of a capital intensive nature suited to large scale manufacture. When used for SME, it results in low capital/output ratio. With regard to labour, the skills base of turning an unprocessed good into a semi or processed product is slim albeit scarce. This results also in low labour/output ratio. It takes more labour hours or man resource to produce an innovative small scale product in Namibia. Hence technology is still a major constraint in Namibia in terms of the SME's and hence there is a need to introduce more small scale technologies suited for SME development and for a technological knowledge through skills formation. Greater efforts are done in terms of skills training in Namibia such as the establishment of the National Training Authority and more exposure in terms of targeting capital technology which are more understandable and suited for SME production need to be encouraged.

There are other challenges such as the regulatory environment which is not favorable to serve as an incentive to SME development. Overall, this has currently been attended to, to a fair degree. Other challenges revolves around the programmes designed to overcome constraints towards the development of the sector in the areas of marketing, technology transfer, purchasing of inputs by SME and sites and premises for SME to operate from, and institutional support, whereby the Ministry of Trade and Industry serves as the lead ministry for the small business sector. The government has successfully launched and implemented the above mentioned programmes. This is clearly manifested in the increase in SME contribution to the economy in terms of growth promotion and jobs creation.

But allow me at this juncture to focus on a very important point that has a bearing for the SME in the globalised world. The limited access to

technology, low level of skills training, financing problems would increasingly become greater challenges to bear because of the stiff global competition. As we all know, we are in a globalised world where it is impossible to turn back the clock. Internationally and even regionally among our SADC members, we must care to understand that the logic of competitive pressure squeezing out inefficiencies and improving the value for the consumers' money is a prevailing business logic in today's world.

Hence, Namibia as a country among nations cannot afford to be isolated from the rest of the world. We all know that the US, Japan, and Europe are all members of the WTO and that they are pushing the WTO agenda as a force representing 80% of our country's trade. Near home, South Africa is an economic giant within SADC that is pushing already an export push within other SADC states, including Namibia. How does SME in Namibia position themselves, to take advantage of engaging in production methods and outputs that can make them developmental on a sustainable basis to aid in economic growth and poverty reduction, given globalization?

There are only two things to do. Firstly SME's must gear themselves to become more competitive and progressive. This process involves whereby SME's need to be informed on taken advantage of possible competitive sources that offers price discounts on their raw materials and inputs for their production processes. The imminent reduction of tariffs in line with WTO requirements and the creation of different sources for SME raw materials such as EU and US through the Free Trade Area agreements can ideally offer the possibility for SME's to buy their raw materials for value addition at reduced prices. There might also be a cheaper source of technology



offered through Brazil and India that is SME viable and specific to its production processes.

SMEs need to think global and not local and find innovative ways to access markets from SADC. It needs to create a niche marketing strategy where it identifies key products and services that are unique to be sold to the outside world. In this context, concerted effort must be made to ensure that current distribution channels and marketing information from bigger companies in Namibia that are linked global and regionally are availed to SME's at a substantial subsidized costs to market its products globally. Here a number of handicrafts and manufactured goods which are suitable for exporting can be considered. Joint ventures with big companies may need to be established so that SME's can tap into the expertise to ensure that it fulfills a particular niche market for its products. Think of a Rhino/Elephant and a bird building its nest on the back of the Rhino.

The second strategy to embark on is to be aware what SME's we are targeting for global and regional competitiveness and be aware of successes and failures in terms of progress and how to learn to manage them. In order to identify such competitive products and services, I am encouraged to compliment NEPRU in cooperation with JCC to come up with a "*Small Business Impact Assessment 2003*" study that comes up with clusters of eight that can ideally ensure a distribution along the continuum which products and services could be termed competitive, and which are not. By having such clusters can we ideally identify those products of SME now that we think we may be regionally and globally competitive, and for that the government should be available to support them.

Such products and services competitiveness may also have to be internalized within the Free Trade Area agreements and negotiating process with the global world so that these products and services can find a global niche worthy to penetrate into.

The first competitive profile that I can pose is those products and services which can be considered already competitive on the global and regional markets. Such products may be leather artwork, textiles (marketed competitively through the AGOA), tourist products, hospitality, and handicrafts unique to Namibia.

Second, we must identify products and services of SMEs where we are marginally competitive or marginally uncompetitive. Since they are marginally competitive globally, they may still be competitive domestically and regionally and hence they can still become another peg for the economy. Such products may be construction, maintenance, carpentry, transport, ICT, body care etc.

Third, there are products and services where we are not competitive, and where the prospects for becoming competitive are quite remote. I would say that at the moment that most of our products and services are falling in this category from SME's. This includes food, *Kapana*, furniture, metalwork, etc. This is also where many of our people derive their income from these products and services. There needs to be a concerted effort made to transform these products and services. We may modernize and innovate

*Kapana* into a worthwhile product packaged and branded domestically and sold to the domestic market, even regionally.

The government needs to intervene to manage such a transition. Another example which is indeed commendable of this is the Green Scheme in the agriculture sector. For example, dates, grapes, cotton and vegetables are earmarked as developmental products which can be SME driven. The Government and the private big companies may need to help them and manage the transition so that they can modernize and sell their products competitively.

Finally, there are products and services which are deemed uncompetitive but growth oriented to satisfy domestic markets and from which only a few derive their incomes. This may include electronics and business consulting. In this case, it is necessary to identify them and avoid focusing our modernizing efforts on them and rather divert assistance to areas that would bear competitive products. This is essentially the competitive framework that I propose to the government of Namibia and that the private sector alike should operate and assess continuously and ensure managing its interventions.

Hence it's essential that a competitive profile can be established taking the cluster so far developed to engage in sectoral review of SME's doing the road maps for each. The road maps should record whether the uncompetitiveness of some clusters are situational and thus remediable through agricultural modernization for instance or are systemic. If they are

systemic, we must either termed them uncompetitive and focus our energies on where we can get SME's to grow competitively and sustain ably.

In conclusion, allow me to state that I may have focussed on key major challenges. There are others which I think has been dealt with in the past literature such as the challenge of lessening gender inequality and ensuring that the previously disadvantaged gets into the mainstream of the economy through black economic empowerment. It is therefore encouraging to quote NEPRU 2003 Impact Assessment Study Report that about 37 per cent of the businesses surveyed in Namibia are owned by women and 93.4 per cent of the business owners can be classified as previously disadvantaged Namibians. SME in Namibia are therefore not only playing a significant role in terms of their contribution to GDP but equally in terms of addressing social evils such as poverty and inequality.

In conclusion, one can conclude that the SME sector in Namibia has flourished and met most expectations. However, the issue of access to capital, entrepreneurial development, and enabling regulatory environment as well as competitive strategies pose serious challenges that require active government and private sector involvement if the huge potential in this sector is to be harnessed.

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