Global Value Chain, SME, and Policy
Korean Perspective

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KOREAN PERSPECTIVE

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GLOBAL VALUE CHAIN (GVC) AND GVC-ORIENTED POLICY INSIGHTS FROM THE SOUTH KOREAN EXPERIENCE
Joonkoo Lee

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Renato Baumann

2. GLOBAL VALUE CHAIN, SME, AND POLICY: KOREAN PERSPECTIVE
Joon-Ho LEE

3. THE IMPORTANCE OF THE FOURTH INDUSTRIAL REVOLUTION IN GLOBAL VALUE CHAINS
Marcelle Torres Alves Okuno

4. BRAZIL, SOUTH KOREA, AND GLOBAL VALUE CHAINS A TALE OF TWO COUNTRIES
Otaviano Canuto

5. GLOBAL VALUE CHAIN (GVC) AND GVC-ORIENTED POLICY
Leonardo Paz Neves

MAIN REPORT:

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Leonardo Paz Neves

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Global Value Chain, SME, and Policy

Korean Perspective

JOON-HO LEE*
Introduction

The term ‘value chain’ refers to the functional activities of a business that add value to its customers. The concept of a firm’s value chain, first introduced by Porter (1985), seeing a manufacturing (or service) organization as a system, made up of subsystems each with inputs, transformation processes, and outputs.¹

The value chain can be contained within a single firm, a single province or a country. These days, enterprises try to optimize their management of the firm by dividing their activities (of the firm’s value chain) across the world, from the design, manufacturing of components to assembly and marketing, etc., creating international production (or value) chains. More and more products are “Made in the World” rather than made in just one economy.² In this light, a Global Value Chain (GVC) can be defined as ‘the series of stages in the production of products or services for sale to consumers. Each stage adds value, and at least two stages are in different countries’ (World Bank, 2020).

Researches suggest that countries that embrace GVCs grow faster and boost employment.³ The notion of GVC became one of the major issues especially for developing economies because integration into GVCs became a crucial condition for the growth of those countries. International organizations recommend that, in order to promote GVC participation, the notion of GVC must be embedded in the development of industrial policy, and proper conditions for trade and FDI should be provided.

However, it is important to come up with not only the macro-level policy, but also the micro-level policy that supports firm’s integration into GVC, since the phenomenon of GVC has been largely driven by TNCs (transnational companies) and/or MNEs (multinational enterprises) in advanced economies (UNIDO, 2019). In general, these large enterprises are the ones that govern the GVC and set the rules of the game in the GVC. Given that most SMEs are not competing with large enterprises in the global markets but are rather being linked with large enterprises as suppliers of goods and services, one of the major concerns of policymakers that are responsible for SMEs should be developing a policy that facilitates the integration of local SMEs into GVC.

In the case of Korea, MOTIE (Ministry of Trade, and Energy) can be regarded as the government authority responsible for the facilitation of GVC at the macro-level since MOTIE is responsible for establishing FDI policy. But in the case of MSS (Ministry of SMEs and Startups), it is difficult to specifically identify the policies that are related to the issues of GVC. However, in the case of Korea, the policy to promote SME’s internationalization is generally accepted as one of the most important policy measures that enhance SMEs’ access to GVC.

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¹. Porter (1985) defined ‘Inbound Logistics, Operations/Manufacturing, Outbound Logistics, Marketing and Sales, and Service’ as primary activities of a firm. Procurement, human resource management, technological development, and firm’s infrastructure as secondary activities. The secondary activities include activities such as design, R&D, management of human resource.


GVC and Internationalization of SMEs

The term ‘internationalization’\(^4\) can be defined as ‘the process of increasing involvement in international operations’ (Calof & Beamish, 1995; Welch & Luostarinen, 1988).

The holistic approach to internationalization views not only outward aspect of internationalization but also inward aspect of internationalization (Fletcher, 2001). Inward driven internationalization can be seen as a mirror image of outward driven activities such as imports of goods, services, technology, and knowledge, etc., through franchising, licensing, direct investments, alliance agreements, etc (Luostarinen & Welch, 1990).

Considering the notions of a firm’s value chain and holistic view on internationalization, one can consider numerous paths that SMEs can be embedded in GVCs. SMEs can be connected to MNEs by supplying goods and services to various points of activities along the MNEs’ value chain, as well as in various ways of internationalization activities that are identified by the holistic view of internationalization.

Understanding the chain governance structure of GVC is important to promote proper and efficient GVC insertion of local enterprises. From a large perspective, buyer-driven chains and

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\(^4\) Globalization is often confused with internationalization. Internationalization refers to the increasing importance of international trade, relations, treaties, alliances, etc. However, the nation remains as a basic unit (Daly, 1999). Globalization can be defined as a process of economic integration of the entire world through the removal of barriers to free trade and capital mobility, etc. Here the term ‘internationalization’ is used for SMEs considering the limit of SMEs capacity to globalize their businesses.
producer-driven chains can be identified. Currently, five types of governance patterns are generally recognized (Gereffi et al., 2005). Hierarchical chains represent vertically integrated firms. Captive chains involve suppliers or intermediate customers. Relational and modular chain governance exhibit durable relations between lead firms and their suppliers in the value chain. Market chains represent the classic arms-length relationships found in many commodity markets. These five types exhibit the various relationship between entities in the chain, from the type where suppliers are subject to very tight supply chain management of lead firms to where consumers are the governors of GVCs.

It is crucial, especially for policymakers responsible for SMEs, to understand the power dynamics of different GVCs to properly support SMEs’ integration into GVCs. Different GVCs require different strategies. However, considering the nature of SMEs with limited resources (in the context of human resources, capital, technology, etc.), it has to be the role of authorities responsible for SMEs to provide appropriate policies, based on different characteristics of GVCs, to facilitate SMEs integration into GVC.

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**FIGURE 2: FIVE GVC GOVERNANCE TYPES**

Source: Gereffi et al. (2005)

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5. In the case of Korea, more than 80% of all Korean enterprises are small enterprises with less than 10 employees. The proportion of enterprises with less than 50 employees to total is over 97%.
Status of Korea in the GVC and FDI

Korea is generally perceived to be well embedded in GVC. According to the latest report by OECD (2018), the global level of GVC integration has declined since 2011. This trend holds the same for Korea. The foreign value-added contents of Korea’s exports had increased from 32.7% in 2005 to 42.2% in 2011, but sharply decreased to 30.4% in 2016. However, Korea’s share of foreign content of exports nearly doubled since 1995 (22.3%). Also, the current level is still higher than the average of OECD (25.3%), and the highest among G20.

The percentage of imported intermediate inputs used for export slightly decreased from 53.7% (2011) to 50.6% in 2015. But the level is still above the OECD average of 45.5% (2015), and also above the OECD average of 2005 (44.4%). Of the total domestic value-added produced by the manufacturing sector in Korea, 60% was driven by foreign final demand in 2015. The level was approximately 52% in 2005. Given these indicators, Korea can be assessed as one of the top countries that are actively integrated within GVC from a global perspective. However, considering the current status of FDI to Korea, concerns are raised over the long-term trend of Korea’s participation in GVC.

FDI is considered as one of the most important and generally accepted policy measures that can enhance the integration of developing economies into GVC (Amendolagine et. al. (2017), Taglioni & Winkler (2016)).

In the case of Korea, FDI did not play an important role, at least in the early stage, in the economic development history. Since the end of the Korean War, capital resources needed for the development of the economy have mostly raised by official government loans. The policy had changed after the 1997 Asian Financial Crisis. The annual average amount of FDI to Korea in the 1980s was 550 million dollars (on a reported basis). The amount increased up to 15 billion dollars in 1998 and recorded 269 billion dollars in 2018 which was the highest in history. However, it was reported that FDI to Korea had decreased by 37% in the first half of 2019 compared to the same period of 2018. During the same period, FDI to the manufacturing sector had decreased by more than 57%, and FDI to the service sector had also dropped by 19.7%. But, it was found that FDI to the U.S increased by 3.9% and 3.5% to China in that same period.

It is difficult to identify why Korea currently is underperforming to attract FDI compare to other competing economies. The fundamental reason may be found in its complicated, opaque, and country-unique regulatory framework that does not comport with global standards (U.S. Department of Commerce, 2019). However, it can be speculated that the latest policy direction of Korea could be one of the main causes of the recent decline in FDI. The current regime increased the minimum wage rate by 16.4% in 2018. The annual average rate of the minimum wage increase was around 7% from 2013 through 2017. The Korean government enacted the law that reduced standard weekly working hours from a maximum of 68 hours to 52 hours in 2018, and raised corporate tax rate at the same time.

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6. The Trade in Value Added (TiVA) considers the value added by each country in the production of goods and services that are consumed worldwide. TiVA method eliminates the double/multiple counting problem in traditional trade statistics.

7. Korea lowered its highest corporate tax rate (25%) to 22% in 2009, but raised it back in 2018. Currently, firms with taxable profits of more than (approximately) 250 million dollars, including levies paid to regional administrations, are subject to a tax rate of 27.5%.
According to the survey on (foreign capital invested) enterprises in Korea, 74% of them pointed out that raising the minimum wage rate while reducing the working hour as the most serious obstacles that hinder doing business in Korea (KERI, 2020). It is assessed that the current administration ran counter to the global competition to forge more business-friendly conditions by increasing the corporate tax rate.⁸

These series of policies appear to have given the global market and foreign investors a message that the current regime is likely to be more favorable to workers than companies. Given that the MNEs are the ones that set the rules and lead the game in the GVC, it is worried that the current changes in the policy direction of Korea might not be considered as favorable environment for foreign enterprises to invest or to look for business partners in Korea.

In the case of Korea, SME supporting policy can be identified in two aspects. One aspect is to identify it by policy sectors.

MSS (Korea Ministry of SMEs and Startups) classifies SME supporting policy into six sectors; 1) Finance, 2) Technology, 3) Human Resource, 4) Export, 5) Marketing and sales channel, 6) 4th industrial revolution. The other aspect is to identify it by the policy targets. MSS classifies SMEs into 5 categories; 1) general SME, 2) startups, 3) Micro firms, 4) venture company, and 5) self-employed business.

In principle, MSS establishes SME support strategies, policies, and enacts laws. However, all other ministries in Korea are also taking roles in supporting SMEs according to their characteristics.⁹ The difference between MSS and other ministries is that the policy target of MSS is restricted to SMEs, while the rest of the ministries are providing policy programs for all sizes of enterprises.¹⁰

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⁹. Total number of SME supporting policy programs is approximately 16,000 including those provided by both central and governments.
¹⁰. For example, the Ministry of Agriculture, Food, and Rural Affairs (MIFRA) provides policy programs to support Korean companies in the agriculture and food sectors. The MOTIE provides R&D supporting policy programs for all sectors of Korean enterprises regardless of their size. On that account, it can be said that the whole ministries are in support of all Korean enterprises including SMEs. However, given that more than 99% of all Korean enterprises are SMEs, it can be considered that majority of beneficiaries are SMEs.
Internationalization and SME export supporting system of Korea

Before the introduction of a holistic view, the generally accepted concept of a firm’s internationalization had been ‘Stage model’ (Johanson & Vahlne, 1977). The Stage model describes internationalization as ‘changes involved with a firm, as it increases its commitment to global markets,’ and the model focuses on the outward aspect of internationalization such as export of goods and services.

This concept that emphasizes the outward aspect of internationalization still prevails and dominates the mind of policymakers. Korea is no exception. No policy termed as internationalization in the policy category of MSS, while policy measures to support export are in the category.

In the case of Korea, 14 ministries (including MSS) provide 60 different SME export support policy programs (in a broad category), which are 225 policy programs and services in a detailed category, as of 2016. Different Ministries are offering different export supporting programs according to their characteristics. The ministries operate various ‘policy implementing’ organizations under their umbrellas, and many of them are directly or indirectly related to supporting SMEs. In the case of MSS, there are 9 organizations under the umbrella of MSS. All these MSS-related organizations and some of other policy implementing organizations (of ministries other than MSS) are interrelated in providing SME export supporting policies.

MSS classifies export supporting targets into 5 groups; 1) SME with no export record, 2) beginner of export, 3) SME with export potential, 4) SME with potential for innovation and export, and 5) globally successful SME. Export support policy programs can be classified into three categories; programs for 1) establishing export infrastructure, 2) export capacity building and 3) international marketing.

Offline and online SME export supporting platforms (export promotion agencies, websites, online shopping malls, etc.), information provision systems, training/education programs, etc. belong to export infrastructure. Capacity-building includes financial and technical support programs, programs to support acquisition of certificates and patent registration, etc. Export marketing generally includes programs that enhance SMEs’ participation in exhibitions and trade fairs, relieving burdens of logistics, provision of consulting and counseling for international business, etc.

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11. A current research concluded that the EU portfolio of instruments that support internationalization seem to focus primarily on export and trade promotion without necessarily stimulating internationalization of innovation activities of SMEs (Lilischkis et al., 2016).

12. There are 339 public policy implementing government organizations in Korea as of 2019.

13. KOSME (Korea SMEs and Startups Agency) is the most important one of all, which was established in 1979 while MSS was established in 1996. All other organizations were established since the early 1990s. TIPA (Korea Technology and Information Promotion Agency for SMEs) supports R&D of SMEs. SEMAS (Small Enterprise and Market Service) focuses on supporting micro enterprises. SBDC (Small Business Distribution Center) supports SMEs’ domestic marketing and securing sales channels. KOREG (Korea Federation of Credit Guarantee Foundations) and KIBO (Korea Technology Finance Corporation) provide guarantees for SMEs. KVIC (Korea Venture Investment Corporation) supports venture companies. KISED (Korea Institute of Start-up and Entrepreneurship Development) specializes in promoting start-ups. KDSBI (Korea Small Business Research Institute) is the policy research institute. Further details are beyond the capacity of this report.

14. In general, programs can be one of 50 programs (in broad category) implemented by government-related organizations. Services include various practical measures of operating a certain program and/or one of 225 policy programs (in a detailed category).
Three major organizations, among others, are worth noting. KOTRA (Korea Trade-Investment Promotion Agency) and KITA (Korea International Trade Association) are the two major export promotion agencies in Korea. While KITA and KOTRA dedicated to supporting only export, KOSME is supporting not only SMEs’ export but also all categories of policies; finance, technology, marketing, human resource development, education, etc. This comprehensive role of KOSME in supporting SMEs is possible because all policy programs and policy implementing organizations are under the control of MSS.\(^{15}\)

Policy Implications

Given that the current status of Korea in GVC involvement, especially in the global production chain of manufacturing sectors, it seems that the Korean economy as a whole is fairly well embedded in the GVC. However, recommendations from the micro perspective can still be addressed to further facilitate the integration of SMEs into GVC.

First, policymakers should be aware of the holistic view of internationalization in supporting the integration of SMEs’ into GVC. It has to be noted that export is not the only form of doing international business or the only path being connected with GVC. Most government authorities, including Korea, tend to (over)emphasize the role of exports in facilitating the internationalization or GVC insertion of the economy, and provide policies that focus mostly on export-related supports. However, there are various forms of internationalization and various paths that SMEs can integrate into GVCs.

In this regard, it is recommended to provide orchestrated supports (of various policy measures) for SMEs’ internationalization or exports. These days, in the case of Korea, it is hard to explicitly differentiate export supporting programs from other policy programs because the majority of export supporting programs are provided as a package. There is a tendency such that various SME supportive measures (that support the development of technology, human resources, finance management, etc.) are mixed up in a particular export supporting program, and various organizations need to be involved to implement the programs.

15. See Lee et al, (2018) for detailed introduction to Korean SMEs’ export supporting policies and policy implementing organizational structure.
From the same perspective, it is recommended to encourage the inward aspect of internationalization in supporting international business activities of local enterprises. Various forms of inward internationalization can facilitate international business activities of internationally inexperienced domestic enterprises by exposing them to the international business environment. This will provide SMEs with more chances to connect with various GVCs governed by MNEs. Furthermore, it is postulated that inward internationalization can ultimately enhance outward internationalization of enterprises.

Second, policymakers should make efforts to identify the policy target’s needs as often as possible. It has been reported that there is a misconception between SMEs and policymakers on what SMEs want for internationalization (OECD & APEC, 2006). Despite the overly excessive, in a certain sense, export supporting policy measures, Korean SMEs are still struggling to find out appropriate connections to global business partners and markets.

According to the survey on Korean SMEs regarding obstacles of exports and overseas market entry, more than one-third of the respondents pointed out that the lack of information on foreign buyers and business partners as the most important export-hindering obstacles. About one-third of them pointed out the lack of information on foreign markets as the obstacles while less than 20% answered that the lack of capacity to conduct international business.

Information on overseas markets and potential buyers or business partners is crucial for SMEs to identify the chain governance status of their target GVC, and to set up the GVC entry strategy. However, despite the existence of various export supporting policy programs and organizations, it seems that the focus of government support was not able to pinpoint the needs of SMEs in the real world of business. It is the role of government authorities to provide what SMEs want, not what authorities want to provide.

<table>
<thead>
<tr>
<th>TABLE 1: MAJOR OBSTACLES HINDERING EXPORTS (SMES, 2018)</th>
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<tbody>
<tr>
<td>OBSTACLE</td>
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<tr>
<td>Limited capacity to find foreign buyers and/or foreign distributors</td>
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<tr>
<td>Lack of information on foreign markets (e.g., consumption trends, size of the market, consumer preference, etc.)</td>
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<tr>
<td>Inability to find foreign partners for the strategic alliance, joint investment, etc.</td>
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<tr>
<td>Lack of information on local laws, regulations, business customs, business practices, etc.</td>
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<tr>
<td>Lack of production capacity (access to production financing, securing production facilities, compliance with the delivery date, etc.)</td>
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<tr>
<td>Limited access to trade financing</td>
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<tr>
<td>Lack of human resource (incapable of hiring experienced personnel in international businesses – international contract, customs clearance, opening L/C, etc.)</td>
</tr>
<tr>
<td>Lack of information on competitors and their products in the market, local logistics, customs clearance, etc.</td>
</tr>
<tr>
<td>Insufficient (integrated) consulting system for international business</td>
</tr>
<tr>
<td>Lack of resources for acquiring international standards, foreign certificates</td>
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Source: Center for Large and Small Business Cooperation

Third, It is recommended to encourage inter-firm relationships between domestic enterprises. Government authorities, at least in the case of Korea, tend to perceive that direct linkages to MNEs

16. The survey was conducted on 1,020 SMEs, which participated in the training and consulting programs provided by the CLSC for 3 years (2015 – 2018).
as the prominent passage of internationalization or SME’s GVC integration. But, the local SMEs that supply goods and services along the value chain of large domestic enterprises, especially the exporting large enterprises, can also be regarded as being integrated with the GVC.

Direct export of Korean SMEs accounts for approximately less than 20% of total exports. However, considering the heavy industry nature of Korea that requires intensive vertical production chain, the volume of indirect-export of SMEs is considered to be large.\(^\text{17}\) The proportion of indirect-export of Korean SMEs in the automobile and shipbuilding sector was assessed to be about 30% and 62% respectively (Lee, 2010). This implies that Korean SMEs are indirectly integrated into GVCs through the production chain of Korean large enterprises.

Korea has been emphasized the role of exporting-enterprises in the history of economic development. Excessive preferential measures were provided to facilitate export and to support exporting enterprises to become large enterprises. At the same time, the strong inter-firm relationship between domestic companies (which lasted until the 1997 Asian Financial Crisis) was encouraged at the government level. Policy attempts to keep the production chain within the domestic boundary were pursued, and various policy supports were provided to support the competitiveness of the linkages.

Despite the criticism such that the relationship intensified inequalities between large enterprises and SMEs, it is postulated that the long-term relationship played an important role in obtaining the global competitiveness of both large enterprises and SMEs of Korea. And, lessons and experiences learned from the domestic inter-firm relationship could help local SMEs to do the international business with MNEs that would require much higher standards of doing business in the global market.

Fourth, it is recommended to make use of digital instruments. It must be noted that SMEs are not the ones that choose their business partners in the GVC. MNEs are the ones that govern the GVC and choose the right sourcing partners at the right time and locations for their GVC. This means that it has to be SMEs that provide information for MNEs to use the information in selecting potential suppliers. However, considering the limit of SMEs’ capacity, the government should be responsible for establishing a system to provide integrated information on local SMEs.

Digitalization provides a useful means of overcoming temporal and geographical limits for both players of the game (SMEs and MNEs) and the government authorities (the facilitator of the game). Since the early 1990s, the Korean government began to make efforts to transform the whole trade-related infrastructure of Korea based on digital technologies.\(^\text{18}\) According to the report of World Bank (2013), Korea ranked as the 3rd easiest country to trade across borders due to the digitalization of trade-related systems. The digitalization of export-related systems helps to integrate the information needed for foreign investors and customers so that they can have easier access to the information on potential suppliers.

In that regard, it is also recommended to encourage the establishment of SME clusters based on the characteristics of their business sectors (or industries). Establishing clusters is a convenient and effective way, from the aspect of policy providers, to support the development of technology, human resources, and SMEs’ access to finance, etc. It is also a convenient and effective way for MNEs to find potential suppliers in the local market.

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\(^{17}\) Here, the term ‘indirect export’ implies SMEs’ involvement in the (export) production chain of large enterprises by supplying parts, components, modules, labors, etc.

\(^{18}\) Here, the trade-related infrastructure refers to all kinds of trade supporting systems including trading system, customs clearing system, information providing system, organizational system, and etc.
Fifth, policymakers should be aware of notions of the “smile curve.” It is reported that “Gains from GVC participation are not automatic. Benefits of GVCs can also vary considerably depending on whether a country operates at the high or at the low end of the value chain” (OECD-WTO-World Bank, 2014). In general, it has been identified that MNEs of developed economies are located at the high-value generating chains while most SMEs (or business partners) of developing economies are located at the low-value generating stages in the GVC (such as product manufacturing or assembly).

The case study on the garment and textile GVC in GMS (Greater Mekong Subregion) depicts the current status of countries involved in the GVC (Abe et al., 2020). It can be seen that the U.S, EU, Japan, and Korea are staged at the high or very high value generating stages of the GVC while GMS countries are embedded in the low and very low value generating stages of the garment and textile GVC. However, not all Korean enterprises of different industries are positioned at the high value generating chains of GVCs.

In the case of Korea, services accounted for 34.7% of Korea’s gross export in 2015, which is significantly below the OECD average of 54% (OECD, 2018). In these days, one of the most important policy agendas of Korea (associated with SME development) is strengthening the competitiveness of the service sector.

SMEs need to upgrade their capacities of conducting both tangible and intangible activities to move up to the higher-value generating chains. Again, considering the fundamental limit of SMEs, it should be the role of government to establish a strategic roadmap (from the national level) and support local SMEs with proper policy measures to drive them to higher value-generating chains.

19. The smiling curve is a graphical depiction of how value added varies across the different stages of a value chain. The concept was first introduced in 1992 by Stan Shih, the founder of Acer Inc. Value added is low in tangible activities (such as product manufacturing and assembly) while it is high in intangible activities (such as R&D, design, brand building, services).
Lastly, the authority responsible for SMEs should be aware of the threats imposed by GVC. An SME’s integration into a GVC may increase the chances of success in the value chain (OECD & APEC, 2006), but a firm’s participation in GVC can imply downgrading of its functions and may result in a reduction in the company’s autonomy (Pena & Arroyabe 2002, OECD 2008).

Globalization and the notion of GVC drive SMEs to face global competition and force them to challenge global standards and regulations. These changes demand SMEs a much higher standard of business capacity than what is required in the domestic market. In general, most local SMEs are short of resources to tackle those challenges and are unlikely to develop an appropriate global strategy to succeed in the new environment.

MNE’s superior status in the GVC presents problems too since they can leverage their governance and bargaining powers in the chain. It is often reported that large enterprises put excessive downward pressure on the price of deliveries, extort technology developed by SMEs, and even intentionally exclude SMEs (with innovative technologies or products) from the market to eliminate the potential threat to their market share. The integration of SMEs into GVC and the survival in GVC is a different issue. Government authorities should facilitate SMEs access to GVCs, but at the same time, should be prepared with legal measures to deal with unfair business practices.

This report outlined several issues on the subject of GVC from the perspective of Korean SMEs. However, Korea has followed different paths of economic development and shares different economic, social, political, and cultural system than that of foreign countries. Implications drawn from the Korean case should be explored with caution. Different countries need different policy measures based on their characteristics.

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