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Trade Policy Uncertainty and Small Firm Internationalisation: A Review and Conceptual Framework

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ABSTRACT: Trade policy uncertainty has moved from the periphery to the centre of international economics over the past decade, driven by episodes including Brexit, the US–China tariff conflict, and the weakening of multilateral trade governance. While a substantial literature now documents the effects of trade policy uncertainty on aggregate trade flows and large-firm behaviour, its implications for small and medium enterprises remain comparatively under-theorised, despite SMEs' distinctive vulnerability to policy volatility. This paper reviews the theoretical and empirical literature on trade policy uncertainty and firm-level export behaviour, and develops a conceptual framework specifying the mechanisms through which uncertainty affects SME exporters differently from large firms: higher relative sunk costs of market entry and exit, narrower market and product portfolios, constrained access to trade finance and hedging instruments, and higher per-unit information costs of tracking policy developments. The framework generates testable propositions concerning market entry deferral, defensive pricing, and premature market exit, and identifies the policy levers — predictability-enhancing commitment mechanisms, SME-targeted trade intelligence, and counter-cyclical trade finance — most likely to mitigate uncertainty's disproportionate burden on smaller exporters. The paper concludes with an agenda for empirical research on SME responses to trade policy volatility.

KEYWORDS: trade policy uncertainty, SME internationalisation, export behaviour, real options, conceptual framework, trade finance, literature review

1. INTRODUCTION

For most of the post-war period, the direction of trade policy in advanced economies was predictably liberalising: successive GATT and WTO rounds lowered tariffs, and firms could plan international expansion against a background of steadily falling trade barriers. The past decade has broken this pattern. Brexit introduced years of uncertainty over the terms of UK–EU trade; the US–China tariff conflict demonstrated that major-economy tariffs could rise sharply and unpredictably; and the erosion of WTO dispute settlement weakened the institutional guarantee that negotiated trade terms would endure. Trade policy uncertainty (TPU) — the inability of firms to predict future trade policy — is now a first-order feature of the international business environment (Handley & Limão, 2017).

A growing empirical literature documents TPU's aggregate effects: reduced trade flows, deferred investment, and supply chain reconfiguration (Caldara et al., 2020). Yet this literature is dominated by analyses of aggregate flows and large, listed firms — the firms for which data are most readily available. Small and medium enterprises, which constitute the overwhelming majority of exporters by count and a substantial share of export value in most economies (OECD, 2021), appear in this literature mainly as an afterthought, despite strong theoretical reasons to expect that uncertainty burdens them disproportionately.

This paper makes two contributions. First, it reviews the theoretical and empirical literature on TPU and firm export behaviour, drawing together strands from international economics, international business, and entrepreneurship research that have developed largely in parallel. Second, it develops a conceptual framework that specifies why and how TPU affects SMEs differently from large firms, generating testable propositions and identifying the policy levers most relevant to SME exporters. The aim is to give the SME dimension of trade policy uncertainty the systematic treatment it has so far lacked.

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2. THEORETICAL FOUNDATIONS

2.1 Real Options and Investment Under Uncertainty

The dominant theoretical lens for firm behaviour under policy uncertainty is the real options framework (Dixit & Pindyck, 1994). Export market entry involves sunk costs — market research, distribution relationships, regulatory compliance, product adaptation — that cannot be recovered on exit. When future trade conditions are uncertain, the option to wait acquires value: by deferring entry, the firm preserves the ability to avoid sunk costs should conditions deteriorate. Handley and Limão (2017) formalise this logic for trade policy specifically, showing that reductions in policy uncertainty — even without changes in applied tariffs — can generate substantial trade expansion by triggering deferred entry, a prediction borne out in their analysis of China's WTO accession.

2.2 Firm Heterogeneity in Trade

The heterogeneous-firms trade literature initiated by Melitz (2003) establishes that exporting is concentrated among the most productive firms, precisely because sunk entry costs create a productivity threshold below which exporting is unprofitable. Uncertainty raises this threshold: the option value of waiting is largest for firms nearest the margin of profitable entry — disproportionately smaller firms. The framework thus predicts, rather than merely permits, that TPU's extensive-margin effects (entry and exit) will be concentrated among SMEs, while large incumbent exporters adjust mainly on the intensive margin (volumes and prices).

2.3 Resource Constraints and the Liability of Smallness

International business research adds a complementary perspective grounded in the resource-based view: SMEs face binding constraints on financial, informational, and managerial resources (Knight & Cavusgil, 2004). These constraints translate uncertainty into cost in specific ways. Hedging instruments and trade credit insurance carry fixed costs and minimum scales that exclude small transactions. Monitoring policy developments across jurisdictions is a fixed cost per market that weighs more heavily on firms with small export volumes. And thin management teams cannot dedicate specialist attention to trade compliance. The result is that a given level of environmental uncertainty imposes a higher effective burden per unit of export activity on smaller firms.

3. EMPIRICAL EVIDENCE

3.1 Aggregate and Large-Firm Evidence

The empirical TPU literature has established several robust findings. Measures of trade policy uncertainty constructed from newspaper text, tariff gap data, and firm earnings calls all rise sharply around major policy episodes and correlate with reduced trade growth (Caldara et al., 2020). Firm-level studies of the US–China conflict document deferred investment, supply chain diversification, and price adjustments concentrated in exposed sectors (Amiti et al., 2019). Studies of Brexit find UK firms reduced investment and hiring during the extended negotiation period, with effects proportional to European market exposure (Bloom et al., 2019).

3.2 The Thinner SME Evidence Base

Evidence specifically on SMEs is sparser but consistent with the theoretical predictions above. Survey-based studies report that smaller exporters are more likely to cite policy unpredictability as a barrier to internationalisation than tariff levels themselves, and enterprise-survey analyses find SME export participation more sensitive to uncertainty measures than large-firm participation. Studies of exit behaviour document that once small exporters leave a market, re-entry is rare — consistent with sunk-cost hysteresis first documented by Roberts and Tybout (1997) — implying that uncertainty episodes can permanently reduce the population of small exporters even after policy stabilises. However, most of this evidence is fragmentary, cross-sectional, or confined to single countries, and the field lacks the systematic firm-level panel evidence that exists for large firms.

4. A CONCEPTUAL FRAMEWORK FOR TPU AND SME EXPORT BEHAVIOUR

Drawing the reviewed strands together, the framework proposes that TPU affects SME export behaviour through four mechanisms, each rooted in an identified structural difference between SMEs and large firms. Mechanism one: entry deferral. Because SMEs sit closer to the profitability threshold and face proportionally larger sunk costs, rising TPU raises the entry threshold most for them, deferring or cancelling marginal market entries (Proposition 1: the negative effect of TPU on export market entry decreases with firm size). Mechanism two: defensive pricing. Lacking hedging access, SME exporters absorb expected policy costs in margins to preserve customer relationships, eroding the financial base for continued export investment (Proposition 2: TPU compresses export margins more for firms without access to hedging and trade finance instruments).

Mechanism three: premature exit. Resource-constrained firms facing uncertainty-driven losses exit earlier than resource-rich firms that can absorb transitory losses, and hysteresis makes these exits persistent (Proposition 3: TPU raises export market exit probability more for smaller firms, and exits induced by uncertainty episodes persist after uncertainty resolves). Mechanism four: information under-investment. Because policy monitoring is a fixed cost, SMEs systematically under-invest in trade intelligence, arriving at policy changes unprepared and incurring avoidable compliance costs (Proposition 4: the compliance cost of a given policy change, per unit of export value, decreases with firm size). Together the propositions imply that aggregate trade statistics understate TPU's damage to the small-firm export sector, because the extensive-margin losses concentrated among SMEs are small in value terms but large in firm counts and in long-run export capability.

5. POLICY IMPLICATIONS

The framework identifies three policy levers matched to the mechanisms above. First, predictability-enhancing commitment: binding phase-in schedules, sunset clauses with guaranteed minimum durations, and functioning dispute settlement reduce the option value of waiting and lower the entry threshold — for SMEs especially, the credibility of trade rules matters as much as their content. Second, SME-targeted trade intelligence: public provision of timely, digestible policy monitoring — through export promotion agencies and chambers of commerce — directly addresses the fixed-cost information problem that markets will not solve for small transaction volumes. Third, counter-cyclical trade finance: guarantee schemes and simplified hedging products activated during uncertainty episodes address the margin-compression and premature-exit mechanisms

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at the moment they bind. The framework implies these interventions are complements rather than substitutes, since each targets a distinct mechanism.

6. CONCLUSION AND RESEARCH AGENDA

This paper has reviewed the trade policy uncertainty literature from the perspective of the small exporter and proposed a framework specifying why uncertainty burdens SMEs disproportionately. The immediate research agenda follows from the propositions: firm-level panel studies that interact uncertainty measures with firm size; corridor-level studies of hedging access and margin behaviour; and longitudinal tracking of exit and re-entry around uncertainty episodes. On the policy side, evaluation of SME-targeted trade intelligence and counter-cyclical finance schemes remains almost entirely absent and would be of direct practical value. As trade governance continues to fragment, understanding — and mitigating — the distributional consequences of policy uncertainty across the firm-size spectrum is likely to remain a central task for international business research.

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