

# **Trade, SMEs and Development in South-east Asia**

**CHARLES HARVIE**

University of Wollongong

Wollongong

NSW, Australia 2522

# **Report structure**

- 1. Introduction – Background and context**
- 2. Economic overview of the South-east Asian region**
- 3. Contribution of SMEs to the region**
- 4. SME contribution to new millennium development goals**
- 5. SME bottlenecks and capacity constraints**
- 6. SMEs and Production networks (value chains)**
- 7. SME policies and internationalisation**
- 8. Business support institutions and mechanisms for SMEs**
- 9. Summary and major conclusions**

# Report – major findings

## 1. Introduction - Background

- SMEs are an integral part of the economies of South-east Asia.
- They make significant contributions to regional economies from many perspectives – business numbers, output, growth, employment, exports, entrepreneurial activity, poverty alleviation, economic empowerment, wider distribution of wealth.
- Globalization and closer regional economic integration through ASEAN membership, has presented them with many **challenges** as well as **opportunities**.

## **SME Challenges:**

- **lack of resources/capacity constraints** (finance, technology, skilled labour, market access and market information);
- **lack of economies of scale and scope;**
- **higher transaction costs** relative to large enterprises;
- **lack of networks**
- **market competition and concentration**
- **R&D expenditure and innovation**
- **'churning' and instability**
- **Lack of information** on market opportunities

- Resulting in **inadequate innovative activity, entrepreneurial deficiencies and limited connectivity to domestic and international markets.**
- Capacity constraints can result in a “**missing middle**”, where micro and small firms fail to mature into medium sized enterprises. Medium sized enterprises contribute disproportionately to output, employment and exports relative to their contribution to business numbers and they have a greater capacity to engage in higher value adding activity in production networks.
- Despite these substantial obstacles the South-east Asian region remains **heavily dependent upon SMEs**, particularly for employment generation.
- Addressing these issues is of importance to ASEAN leaders and policy makers and for the **future economic success of the region.**
- **Middle income trap economies (focus on efficiency and innovation)**

# SME Opportunities:

- **niche markets/customization;**
- **discontinuities in production,**
- **product fragmentation** and the rise of **production networks;**
- reduced **product life cycles**/flexible production more important than volume of production;
- **subcontracting** opportunities arising from the growth of the **global production system** in manufacturing (production networks that are particularly strong in the context of East and South-east Asia);
- opportunities arising from **global retail sourcing** (the so-called 'putting out' system);
- increased importance of the **services sector** (dominated by SMEs)

- **knowledge, skills and innovation** as core sources of competitiveness and value adding;
- **reduced bureaucracy**, greater **flexibility** and ability to respond to rapidly changing customer demands and technology;
- **innovation** capacity and ability to initiate and **commercialize innovation in sectors** where **entry costs are lower**;
- **information and communications technology** and utilization of **e-commerce** expanded market outreach and access to information;
- **clustering** (horizontal and vertical) and **networking** can facilitate access to knowledge sharing spillovers, skilled labour as well as achieve economies of scale and scope which would be impossible in isolation;
- **flexibility** in technology development, adaptation and application;
- **Recognition by policy makers** of their importance

## 2. Economic overview of the South-east Asian region

### Economic integration initiatives:

At the core the establishment and growth of the **Association of South East Asian Nations (ASEAN)** – established in 1967 with five members (Thailand, Indonesia, Malaysia, Singapore and the Philippines), Brunei (1984)

Expanded membership in the 1990s to include Vietnam, Myanmar, Laos and Cambodia (CMLV economies).

ASEAN Free Trade Agreement (AFTA) was signed in January 1992 but subsequently lost direction until AFC in 1997-98

### **ASEAN Vision 2020**

## **ASEAN Community 2015 – three pillars**

- **ASEAN Economic Community (AEC)**
- ASEAN Political Security Community (APSC)
- ASEAN Socio-Cultural Community (ASCC)
  
- All of these have their own Blueprint
  
- **Of particular importance is the AEC Blueprint (SME development)**

## The **AEC Blueprint** envisaged achieving the following for **ASEAN**:

- a single market and production base,
- a highly competitive economic region,
- a region of equitable economic development, and a region fully integrated into the global economy.

The AEC is envisaged to be an **open, outward looking, inclusive and market driven economy** consistent with the multilateral trading system, and adhering to a rules based system that is compliant with the implementation of economic commitments.

## The AEC also aims to:

- **integrate industries** across the region to promote regional sourcing and cross border networking
- **enhance the role of the private sector and in particular SMEs** in general and in attaining the previous

## **The ASEAN economy briefly.....**

The ASEAN economy has a market of 625 million people and total GDP of US\$2.4 trillion

Total international merchandise trade is valued at US\$2.5 trillion

FDI valued at US\$122.4 billion in 2013.

Big disparity in economic development between the ASEAN6 and CMLV

**A sustainable ASEAN Economic Community fundamentally depends upon achieving broad based and inclusive growth among its members which will require addressing economic development disparities. Role of SMEs will be critical**

## *Intra and extra ASEAN trade flows.....*

**Much of ASEAN trade is in intra industry commodities**, a reflection of the region's involvement in cross border production networks in both East Asia and globally.

About a quarter of ASEAN's total trade involves trade between member countries, **three-quarters of total trade involves trade with non-members.**

ASEAN needs to remain an open and outward oriented trading bloc with the rest of East Asia and the global economy, as it remains heavily reliant on trade with non-member nations

## ***Trade by commodity.....***

About 70% of total ASEAN trade consists of trade in ten commodity groups:

- (i) electrical machinery and parts, sound recorders, televisions and their parts and accessories,**
- (ii) mineral fuels, mineral oils and related products; bituminous substances; mineral waxes
- (iii) nuclear reactors, boilers, machinery and mechanical appliances; parts and components
- (iv) vehicles and their parts and accessories**
- (v) plastics and related articles

**(vi) optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories.**

(vii) natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal, and articles thereof; imitation jewellery

(viii) organic chemicals

(ix) rubber and articles

(x) iron and steel.

For commodity groups, particularly those involving trade in parts, components and accessories, there is substantial intra industry trade

## ***Intra and extra ASEAN FDI flows.....***

In 2013 the economies of ASEAN received US\$122.4 billion in net FDI inflow, of which **82% was generated from outside the region and 18% was generated from within the region**. Almost half of this net inflow went to Singapore alone. Other major recipients were Indonesia (57% from outside the region), Thailand (90% from outside the region), Malaysia (82% from outside the region) and Vietnam (77% from outside the region).

The major external sources of FDI for the ASEAN economies are the EU, Japan, USA and, increasingly, China. These four sources contributed more than 50% of ASEAN FDI over the period 2011-2013.

# **3. Contribution of SMEs to South-east Asian economic development**

*Context and policy shift*

*Rationale for a Strategic Approach to the Development of SMEs in ASEAN*

Adopting a cooperative approach to the development and integration of regional SMES has the potential to result in increasing social and economic returns within and across ASEAN.

## ***SME Contribution and performance:***

*Business numbers (99% plus, mainly micro 75%)*

*Employment (60-70%)*

*Output (around 50%)*

*Exports (30-35% direct, 50% direct plus indirect)*

*Contribution of SMEs to Growth*

## 4. SME contribution to new millennium development goals

### *New Millennium Development goals, SMEs and ASEAN*

The new millennium development goals (MDGs) consist of 8 objectives:

- \*Eradicate extreme poverty and hunger
- Achieve universal primary education
- \*Promote gender equality and empower women/minorities
- Reduce child mortality
- Improve maternal health
- Combat HIV/AIDS, malaria and other diseases
- \*Ensure environmental sustainability
- Develop a global partnership for development

## ***SMEs and poverty alleviation in ASEAN.....***

**The ASEAN economies have noticeable poverty disparity**

**The CMLV economies having the highest rates of poverty** which are well above that for the ASEAN6 with the exception of Indonesia and the Philippines.

**Addressing this poverty gap represents a major challenge facing the AEC if it is to achieve its objectives of broad based and inclusive growth for ASEAN member countries.**

**Promoting a strong, dynamic and efficient SME sector has the potential to play an important role in this. Studies suggest, however, that this needs to be treated with some caution.....**

There are **five views in the literature which are sceptical about pro SME policies** benefiting economic growth and poverty:

**1. large firm advantages.**

2. SMEs are not more **labour intensive** and better at job creation than large firms

**3. firm size is not an exogenous determinant of economic growth.**

4. **business environment view**, stresses the importance of low entry and exit barriers, well defined property rights, effective contractual enforcement and firm access to finance for competition and private commercial transactions. Focus should not be on SMEs *per se*, but, rather, on the environment facing all businesses and addressing market failures that afflict SMEs directly.

5. **stage of economic development** is important in the determination of optimal firm size.

## ***SMEs, empowerment and gender equity.....***

About **one-third of entrepreneurs in the East Asian region are women**. Women entrepreneurs have an important presence in the SME sector but face numerous economic, social and cultural barriers (e.g. access to finance, legal issues and societal pressures to remain at home and raise a family)

To achieve the **benefits of broad and inclusive growth will require encouraging women, youth and minorities to participate in the process** and benefits of economic growth and development, and doing so by means of establishing SMEs is one possibility.

## ***SMEs and education.....***

There are two dimensions to this:

First, there is the **need to ensure that entrepreneurs have perquisite business skills to start-up and sustain the growth of their SMEs**. Such skills are most likely to be lacking in the CMLV countries, requiring broader assistance from ASEAN6 countries.

Second, there is the broader issue of the education system itself (primary, secondary and tertiary sectors) and its **ability to provide the necessary knowledge and skills that will be essential for a productive workforce including that of future entrepreneurs**.

## ***SMEs and the environment .....***

SMEs can also play an important role in terms of their **green approach to production and the development and usage of green technology**. Flexibility in production can facilitate rapid adoption of renewable energy technology. **The performance of the ASEAN economies is quite good in this context** with the obvious exception of the heavily oil and gas dependent Brunei economy.

## 5. SME bottlenecks and capacity constraints

### *General capacity constraints.....*

Governance

Transaction costs,

Market liberalisation

Non-tariff barriers

Trade facilitation measures

Increased connectivity (internet access and transportation facilities)

Improve basic skills

Product quality, cost efficiency and delivery timeliness (production networks)

ICT competence (e-commerce, participation in inter-firm linkages and networking and production networks).

*Access to finance*

*Access to technology*

*Access to skilled human resources*

*Accessing information*

*Inter-firm networking and clustering*

## ***Others***

*Knowledge acquisition and Innovation*

*Entrepreneurship education and training*

*Missing middle*

# 6. SMEs and Production networks (value chains)

Since the early 1990s international production/value creating networks have developed rapidly, involving many of the countries of East and South-east Asia.

Driving factors:

Intensification of **global competition** (cost, quality and delivery)

Adoption of a **new global business model** focusing upon global markets, global sourcing, flexible production, a focus on core business, subcontracting and outsourcing, knowledge creation, commercialisation and innovation, rapid technological change and production discontinuities, advances in ICT, facilitated by regional, sub-regional and bilateral free trade agreements (FTAs)

Resulting in a production-process wise regional division of labour and production location across countries with different income levels and development stages, and a significant shift away from a traditional north-south pattern of trade to one in which there has been a rapid increase in vertical **intra-industry trade**, particularly in parts and components in the machinery industries, which is gradually dominating trade within the East Asian region more generally and with the South-east Asian economies at the core.

Machinery industries include general machinery, electric machinery, transport equipment and precision machinery (HS Codes (Harmonized System Codes) 84-92). These industries require the production of many parts, components and related technologies, highly suitable for the establishment of production networks.

Intra regional trade also increased

Associated with these developments **FDI flows** have moved from import substituting industries and export oriented confined to export processing zones from which the domestic economy was insulated, to **export oriented network forming type FDI**

## ***Product fragmentation.....***

The above phenomenon is known as cross border production sharing or **fragmentation of production**.

**When trade costs go down, such as from a decline in tariff and non-tariff barriers, connectivity costs and logistics the competitiveness of the whole of East Asia considerably increases and this provides a further boost to intra-industry and intra-regional trade .**

Fragmentation of production has also occurred in conjunction with agglomeration of production. Agglomeration or clustering benefits include knowledge spill-over effects, access to skilled labour, and possible economies of scale, access to finance and the just in time system.

From an **East and South-east Asian** perspective, however, **production/ distribution networks have become quite distinctive and the most developed in the world as measured by:**

Their significance for each economy in the region;

- Their extensiveness in terms of country coverage
- Their sophistication which can involve subtle combinations of intra-firm and arm's length (inter-firm) transactions.
- These networks have developed beyond the original idea of fragmentation

Fragmentation makes sense when.....

- (i) there is **production cost saving in fragmented production blocks**; whereby the firm can take advantage of **differences in location advantages** (lower labour and production costs) between the original position and a new position.
- (ii) incurred **service link costs** involved in connecting remotely located production blocks i.e. costs of transportation, telecommunications and various other types of coordination are lower.
- (iii) the cost of **network set-ups is small**.

Fragmented production/distribution (location and by firm) in an industry is heavily influenced by: the number of parts and components required in the production of the final product; the greater the variety of technologies utilized in the production of these parts and components; and the economic environment within individual countries and for the region as a whole.

# ***International Production Networks and SMEs – Opportunities and Challenges***

## ***Challenges for SMEs in the East-Asian region***

**Significant potential exists for regional SMEs to expand their participation in regional and global production networks. SMEs have the opportunity to play a crucial role both as indigenous and foreign based firms in the network on an arm's length basis in various forms, including subcontracting arrangements and original equipment manufacturer (OEM) contracts. SMEs are also essential components of industrial agglomeration. In this context, not only multi-national SMEs but also local SMEs can be important participants in a vertical arm's length division of labour.**

SMEs possess certain characteristics that may limit their ability to do so

- **lack of access to finance**
- **lack of skill and expertise in organisation and management**
- **shortage of sustainable entrepreneurial drive in the sector**
- **weak innovation culture and an over-reliance on technologies brought in by MNCs**
- **lack of networking**
- **lack of resources and knowledge**

## ***Opportunities for SMEs in the East and South-east Asian region...***

**Production networks provide new opportunities for developing countries, including the CMLV countries in ASEAN, to enter international trade through production sharing and outsourcing. Improvements in ICT have reduced the costs of collaboration and linkages, both within and across border.** International production networks developed from the early 1990s in East and South-east Asia are gradually spreading to other less developed economies in the region (e.g. Vietnam, Cambodia and Lao PDR), to India, Australia and New Zealand, driven by market forces and facilitated by regional, sub-regional and bilateral FTAs.

**Regional economic integration has set off dynamic growth impulses through global and regional production networking.** Facilitated by industrial agglomeration and fragmentation in sequential order.

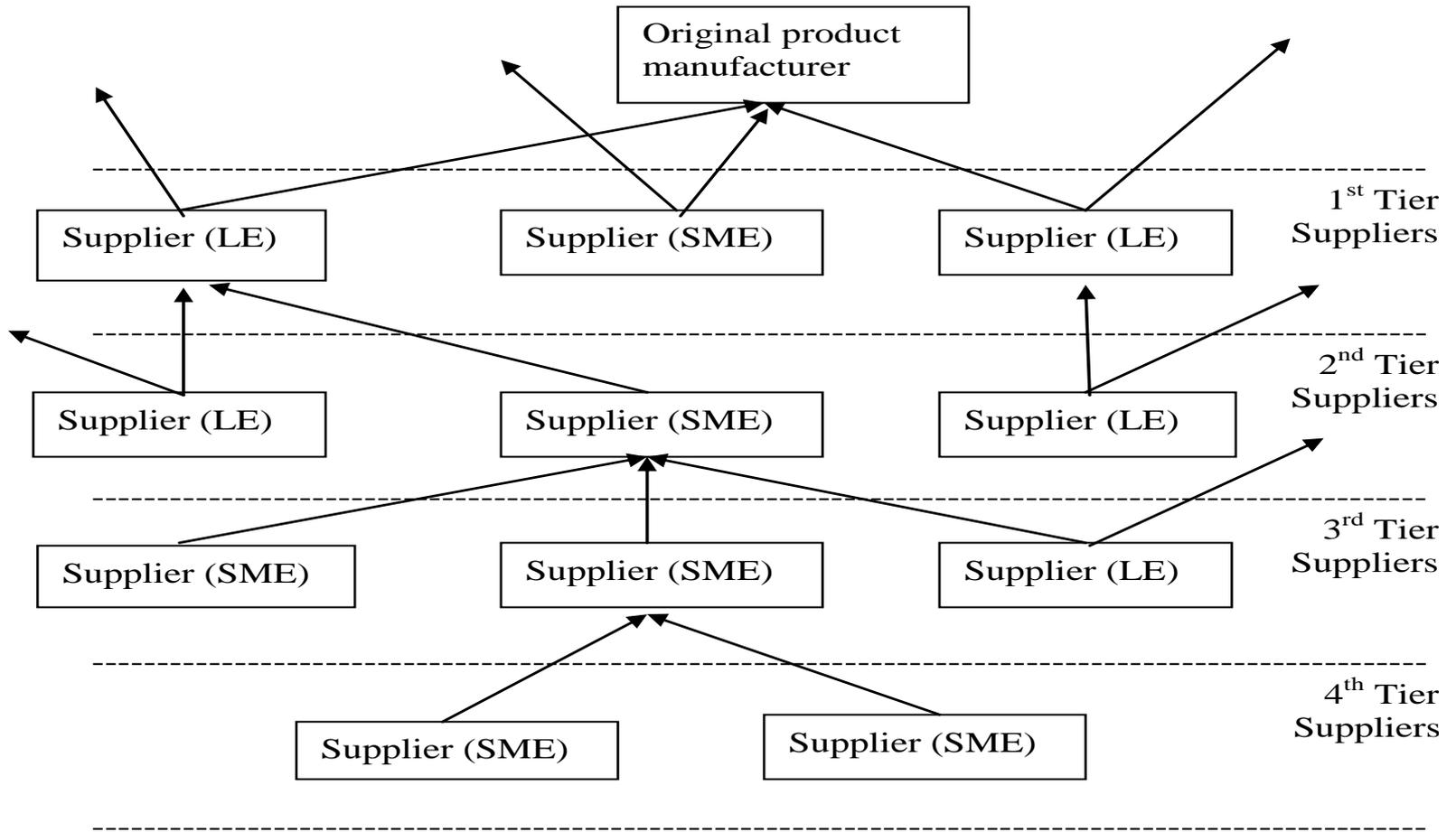
A critical issue is how best to **establish industrial linkages between SMEs, large local and MNCs**. In this context regional governments, and more importantly ASEAN countries as a bloc, will have to play a vital role in ensuring competitive market structures, in providing relevant and effective technical upgrading, marketing information and management, consortium financing, business linkages and facilitate competitive clusters of SMEs

## *The Process of SME Integration into Production Networks*

Global value chains are evolving tiered structures. The main role is traditionally played by a lead firm (multi-national enterprise) that manufactures the final product (Original Product or Equipment Manufacturer). This firm is supported by a small number of preferred first tier suppliers, which are supplied by other suppliers and so on, forming a tiered structure consisting of large and small enterprises (see Figure 2).

It is generally easier to enter a network as a lower tier supplier which SMEs in low income economies tend to do. But this position tends to be unstable as the SME can be easily replaced by other suppliers that offer better comparative advantages such as lower (labour) costs. The challenge facing SMEs is two dimensional. First, to try and **enter a global value chain**, and, second, to also **move up the tiers** by upgrading the added value content of their activities.

**Figure 2 Global and regional production networks and SMEs**



LE – Large enterprise  
SME – small or medium sized enterprise

*Source: Abonyi, 2005*

A study by Harvie *et al.* (2010) identified **key factors that are important for SME participation in a production network**, and then **key factors influencing the participation of SMEs in higher value adding tiers** (tiers 1 and 2 in Figure 2) of a production network using data for seven ASEAN economies plus China.

They found that the key factors and characteristics positively associated with the ability of SMEs to **participate in a production network** were:

- labour productivity,
- foreign ownership share,
- financial stability and cost of credit,
- an ability to meet international standards of their goods,
- had introduced ICT as part of their core business,
- had demonstrated an innovation capability
- had a positive attitude towards risk
- Had willingness to adopt a new business strategy

**Those SMEs that had moved up into higher value adding production tiers had the following statistically significant characteristics:**

- higher labour productivity,
- significant foreign ownership share,
- had ICT as a core part of their business activity,
- had acquired production knowledge and were larger sized SMEs (medium sized enterprises).

The latter point confirms the **importance of addressing barriers that small firms face if they are to expand to becoming medium-sized enterprises.**

## **7. SME policies and internationalisation.**

Post 2015 AEC will require a **clear policy strategy from ASEAN leaders** for the involvement of the private sector, and especially SMEs, **to achieve inclusive and broad based growth in the region.**

**Emphasis on developing cross border production and network linkages, building capacity and enhancing the international competitiveness of regional SMEs are core development policies.**

Considerable emphasis will continue to be put on SME participation in cross border production networks. **This will require improvement in the cost, quality and delivery capability of products and services provided by SME as well as addressing other capacity constraints highlighted in previous sections.**

## 8. Business support institutions and mechanisms for SMEs.

There are many deficiencies in the institutional framework of ASEAN countries that require urgent attention if a vibrant and dynamic SME sector is to be achieved for the region. In this context three aspects are emphasised.

First, there are **weaknesses in the legal framework and excessive bureaucracy.**

Second there are **weaknesses in the institutional framework**, most importantly relating to financial institutions and markets which make it difficult for SMEs to gain access to finance to enable their growth and development (see Beck *et al.*, 2003).

Third, there is **inadequacy in the provision of business development services** particularly in the CMLV countries