TRADE LIBERALIZATION EFFECTS ON THE DEVELOPMENT OF SMALL AND MEDIUM-SIZED ENTERPRISES IN INDONESIA: A CASE STUDY

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The impact of international trade policy reform on the Indonesian economy, particularly in the areas of economic growth and development of the domestic manufacturing industry, has been studied extensively. However, the implications of such reform on the growth of small and medium-sized enterprises (SMEs) in Indonesia remain under-researched. This paper thus contributes to filling the gap by examining the impact of international trade policy reform, particularly following the 1997 crisis, on the growth of SMEs in Indonesia. Two main questions are posited: (a) how does international trade policy reform affect local SMEs?; and (b) has the growth of SME exports accelerated since the reform? The study does not find evidence that the reform has affected SMEs negatively. On the contrary, with the exception of a slight decline in 1998 due to the economic crisis, the number of SMEs has been growing. The paper suggests that such enterprises have not only managed to survive, but they have also been able to increase their output. Their exports also increased annually.

I. INTRODUCTION

The international trade regime in Indonesia has undergone fundamental changes since the 1980s, with a reduction of many tariffs on imports accompanied by a gradual shift from an inward-looking import substitution policy to an outward-looking export promotion strategy. Indonesia has also removed all non-tariff barriers

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and export restrictions. The process of trade policy reform accelerated shortly after the economic crisis of 1997. The Indonesian Government reduced tariffs on all imported food items to a maximum of 5 per cent, deregulated its trade regime in the major agricultural commodities (except rice, for social reasons), terminated production and trade monopolies in certain intermediate industries (cement, plywood and rattan) and reduced export taxes on wood and many other commodities.

The impact of international trade policy reforms on the Indonesian economy, particularly in the areas of economic growth and development of the domestic manufacturing industry, has been studied extensively. However, the implications of such reform on the growth of small and medium-sized enterprises (SMEs) in Indonesia remain an under-researched area. This paper thus contributes to filling the gap by examining the impact of international trade policy reforms, particularly following the 1997 crisis, on the growth of SMEs in Indonesia. In particular, answers to the following two questions are sought: (a) how does international trade policy reform affect local SMEs?; and (b) has growth of SME exports accelerated since the reform?

Following a brief review of the literature available on the effects of international trade policy reforms on SMEs, overviews of international trade reform in Indonesia and of the development of Indonesian SMEs are presented in chapters III and IV, respectively. Effects of the reform on Indonesian SMEs are examined in section V. Concluding remarks and policy recommendations are given in section VII.

II. LITERATURE REVIEW

The Asian region provides evidence of the benefits of external trade liberalization policies (in terms of exports and imports). With its continued growth in external trade, the region continues to generate the highest rates of economic growth in the world, and experienced an average reduction in poverty of about 12.5 per cent between the early 1990s and early 2000. Through external trade, the region has been further integrated into and benefited from the global economy (Bonapace 2005).

In most Asian economies, SMEs are considered the engine of economic growth by virtue of their numbers and their significant economic and social contributions. The role of such enterprises in industrial development is more pronounced in Asia than it is in the West. SMEs in developing Asia account for about 80 per cent of all non-agricultural enterprises, and generate about the same percentage of total employment. In addition, they contribute between 40 and 70 per cent of total value added (Tambunan 2008).

In member countries of the Association of Southeast Asian Nations (ASEAN), SMEs have played increasingly strategic roles, especially in the aftermath of the 1997 Asian financial crisis. As those economies modernize and industrialize, SMEs are providing the much-needed inter-firm linkages required to support large enterprises and ensure that they remain competitive in world markets. In this subregion, SMEs generally account for more than 90 per cent of establishments, between 15 and 57 per cent of total gross output/value added, and between 32.5 and more than 90 per cent of the employment of the domestic workforce (table 1).

Table 1. Non-agricultural small and medium-sized enterprises in members of the Association of Southeast Asian Nations and selected countries in East Asia

Country or area	*Number of non-agricultural SMEs (thousands)*[a]	*Percentage of gross domestic product/value added/output*	*SMEs as a percentage of*	
			Non-agricultural firms	*Workforce*
Brunei Darussalam	30[b] (2004)	..	98.0	92.0
Cambodia	26 (2002)	..	99.0	45.0
Indonesia	21 896 (2006)	57.0 (total value added)	99.9	99.6
Lao People's Democratic Republic	22 (1998/99)	..	99.4	..
	26[c]	..	..	40.0[c]
Malaysia	205	15.0 (total gross output) 47.3 (total value added) 26.0 (manufacturing value added)	99.2	65.1 32.5[d]
Myanmar	34 (1998/99)		96.0	78.0
Philippines	68[e] (2001) 73 (2003)	32.0 (total value added) 25.9 (manufacturing value added) (1998)	99.6 99.0	99.0 47.0[d] (2003)
Singapore	60-72[b]	41.0 (manufacturing output) 34.7 (total value added)	97.8	58.0
Thailand	1 639 (2001)	47.0 (total value added)/40.0 (GDP) (2001)		79.0 (2001)
	2 274 (2006)	38.0 (GDP) (2006)	99.6	76.7 (2006)
Viet Nam	2 700[f]	42.0 (total value added) 39.0 (GDP)	96.0	86/85[g] (2004)

Table 1. ***(continued)***

Country or area	Number of non-agricultural SMEs (thousands)[a]	Percentage of gross domestic product/value added/output	SMEs as a percentage of	
			Non-agricultural firms	Workforce
East Asia[h]				
China	8 000	60.0 (industrial output)	99.0	78.8
Hong Kong, China	292		99.3	60.7
Japan	6 140	52.0 (manufacturing output), 55.3 (total value added)	99.7	77.6
Republic of Korea	2 700	47.5 (total gross output), 50.0 (total value added)	99.8	86.7
Taiwan Province of China	1 050		98.1	78.4

Sources: Tambunan (2006a; 2008, Table III.1).

Note: Figures are for 2002, unless otherwise indicated.

Abbreviations: GDP, gross domestic product; SME, small and medium-sized enterprise

[a] Including microenterprises, unless otherwise specified.

[b] Estimated active.

[c] Excluding microenterprises.

[d] Manufacturing only.

[e] Excluding 744,000 microenterprises.

[f] Excluding 10 million microenterprises.

[g] Total permanent workers/total corporate workforce.

[h] Best guess for 2000.

It is generally believed that trade liberalization should be beneficial for the domestic economy as well as for the world as a whole. At an aggregate level, the channels through which trade reform could bring benefits are, broadly, the following: (a) improved resource allocation; (b) access to better technologies, inputs and intermediate goods; (c) economies of scale and scope; (d) greater domestic competition; and (e) availability of favourable growth externalities, such as transfer of know-how. Until recently, more attention has been given to the macroeconomic effects of international trade reforms.[1] There is now a small but growing empirical literature on the effects of international trade liberalization at a disaggregate level. Theoretically, reform towards international trade liberalization could affect (positively or negatively) local individual firms in four major ways:

[1] Some of the best known analyses are: Krueger (1978), Dollar (1992), and Kruger, Cantner and Hanusch (2000).

(a) *Increasing competition*. Lower import tariffs, quotas and other non-tariff barriers increase foreign competition in the domestic market. This is expected to encourage inefficient or unproductive local firms to try to improve their productivity by eliminating waste, exploiting external economies of scale and scope, and adopting more innovative technologies; if they cannot, the pressure is expected to force them to shut down. Greater openness of an economy to international trade leads to larger enterprises, because local firms adopt efficient technologies and exploit economies of scale;[2]

(b) *Lowering production costs through cheaper imported inputs*. Local firms benefit from lower input costs, which allow them to compete more effectively in domestic markets against imports and in export markets;

(c) *Increasing export opportunities*. Opening up to international competition will not only induce increased efficiency in domestic firms but will also stimulate their exports;[3]

(d) *Reducing availability of local inputs*. Eliminating export restrictions on unprocessed raw materials will increase export of the items at the cost of local industries.

In the case of SMEs, it can thus be expected that international trade liberalization that increases foreign competition in the domestic market will hurt some inefficient or uncompetitive SMEs, while benefiting efficient or competitive SMEs. The efficiency effects of foreign trade liberalization may lead to an increase in average plant size among SMEs and (presumably) lower average costs. The international literature on the effect of foreign trade policy on SMEs presents, however, some surprising and important findings. The seminal work of Tybout (2000) on the microdynamic effects of international trade liberalization on manufacturing firms in developing countries, for instance, consistently shows just

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[2] This is in line with the general theory in which size is predicted to positively affect export performance of firms. The new international trade theory posits a positive impact of market size in view of economies of scale. It argues that the scale economy provides cost advantages in production, research and development and marketing efforts. See for instance, Tybout (1992) and Bonaccorsi (1992). The literature associated with export marketing suggests that large enterprises have greater resources for gathering information on markets in foreign countries and covering the uncertainties of a foreign market (see, for example, Wakelin 1997). It is therefore generally expected that large enterprises are likely to be more export-oriented than small and medium-sized enterprises.

[3] This is generally supported by econometric results. See, for example, Aggarwal (2001) and Tybout, de Melo and Corbo (1991).

the opposite: that increases in import penetration as well as reductions in protection are associated with reductions, not increases, in plant size. Thus, an important finding of that study is that liberalization, rather than improve efficiency immediately, may work against the scale efficiency of SMEs in the short run (or if there are gains in efficiency, they are quite small).

Tybout's findings are supported by Tewari's (2001) findings regarding the experience of Tamil Nadu, India, over the past 15 years. The government removed restrictions on many industries, allowing anyone to enter, and simultaneously liberalized trade. Shortly thereafter, there was a spate of relatively small firms entering those industries, notably textiles. Firms with 400 to 500 spindles set up shop, in contrast to the plants with 10,000 to 20,000 spindles that larger firms operated. By the mid-1990s, the average plant size in the spinning industry had fallen significantly.

Valodia and Velia (2004) investigated the relationship between foreign trade liberalization at the macrolevel and its micro- or firm-level adjustment effects in the South African manufacturing industry. Their findings suggest that there is a strong relationship between firm size and international trade. Most firms servicing only domestic markets are SMEs, whereas the majority of exporters are large enterprises; almost half of exporters are firms with more than 200 workers. It seems that larger firms have been more successful at integrating their manufacturing activities into global chains of production.

Tewari and Goebel (2002) studied SME competitiveness, also in Tamil Nadu. They found two interesting facts. First, SMEs are doing better in some industries than in others; just as some industries are doing better than others. Second, SMEs tied to low-end market segments in large urban or metro areas appear to be the most vulnerable to cheap import competition. SMEs serving similar niches in the rural areas or in small towns do not face the same pressures. Their access to intricate, socially embedded distribution networks that link them to rural markets appears to be a source of strength that non-local competitors find too costly to replicate.

Others, such as Kaplinsky, Morris and Readman (2002), Roberts and Tybout (1996) and Roberts (2000), suggest that the path to growth for SMEs in a trade-liberalized world lies in their ability to compete with imported goods and services. This, in turn, depends greatly on their ability to upgrade their production capacities, their access to human resources and new technology, and their ability to improve the quality of their products.

III. SME DEVELOPMENT IN INDONESIA: AN OVERVIEW

In Indonesia, SMEs have historically been the main players in domestic economic activities, especially as providers of employment opportunities, and hence generators of primary or secondary sources of income for many households. For low-income and poor farm households in rural areas, SMEs, especially small enterprises (including microenterprises), in non-farm activities are a particularly important source of employment. As a group, these enterprises have also been an important engine for the development of local economies and communities. However, compared with more developed economies, Indonesian SMEs are not yet contributing significant value added to the national economy. Instead, they have been more important as the locus of employment.[4]

Though no data are available to show how many SMEs operate in the informal sector, it is generally believed that numbers are high, particularly with respect to microenterprises. The informal sector refers to the part of the economy that operates outside the ambit of organized economic activities. The sector is characterized by: (a) ease of entry; (b) reliance on indigenous resources; (c) family ownership of enterprises; (d) small scale of operations; (e) lack of formal systems of organization; (f) low and uncertain incomes; (g) labour-intensive and adapted technology; (h) skills acquired outside the formal school system; (i) no social welfare or security; and (j) unregulated and competitive markets. In Indonesia, the informal sector played a crucial role during the economic crisis in 1997, as it absorbed many people who had lost their jobs in the formal sector.

Typically, SMEs in Indonesia account for more than 90 per cent of all firms, and thus they are the largest source of employment, providing a livelihood

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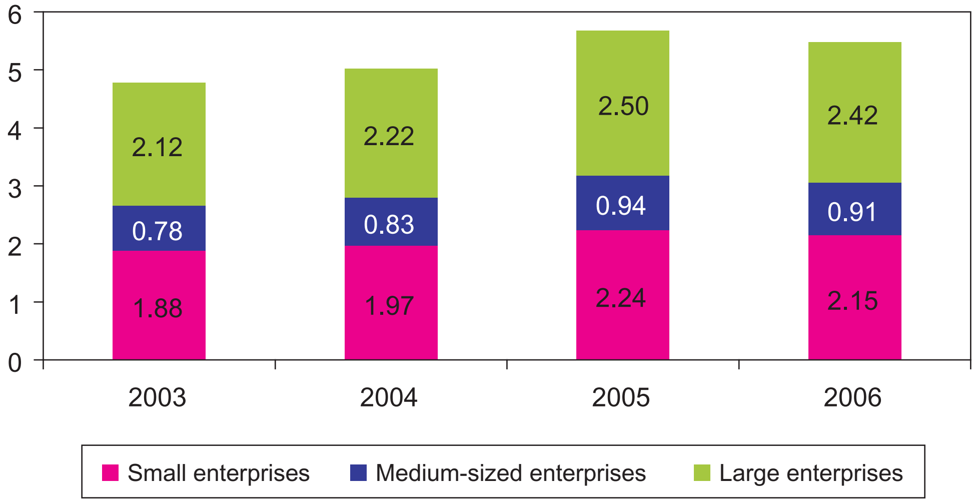
[4] In Indonesia, there are several definitions of small and medium-sized enterprises, depending on which agency provides the definition. As the present paper uses data from the State Ministry of Cooperative and Small and Medium Enterprises (Menegkop & UKM), the Ministry of Industry, and Statistics Indonesia (the central statistical agency), only the definitions of these three government agencies are used. Menegkop & UKM promulgated the Law on Small Enterprises No. 20 of 2008, which defines a microenterprise as a business unit with total initial assets of up to 50 million rupiah (Rp), not including land and buildings, or with an annual value of sales of a maximum of Rp 300 million. A small enterprise is defined as a business unit with total initial assets of up to Rp 500 million, or with an annual value of sales of a maximum of Rp 2.5 billion, and a medium-sized enterprise as a business unit with total initial assets of up to Rp 10 billion or with an annual value of sales of up to Rp 50 billion. Statistics Indonesia, which regularly conducts surveys of small and medium-sized enterprises, uses the number of workers as the basis for determining the size of an enterprise. In its definition, micro-, small and medium-sized enterprises are business units with, respectively, 1-4, 5-19, and 20-99 workers, and large enterprises are units with 100 or more workers. The Department of Industry categorizes an enterprise by its size in its sector and according to number of workers, following the Statistics Indonesia definition.

for over 90 per cent of the country's workforce, especially women and youth. The majority of SMEs in Indonesia are very small (microenterprises), and are scattered widely throughout the rural areas. Microenterprises are the most traditional enterprises, dominated by self-employment units without hired paid workers. They generally use primitive methods of production, generally with low levels of productivity, and produce poor quality goods mainly for local markets. There is little or no technological dynamism in this group of enterprises, and the majority provide barely a subsistence-level living. Some are economically viable over the long term, but many are not. Given such characteristics, microenterprises have more difficulties than SMEs in facing changing technology and the growing demand for higher quality, modern products.

Indonesian SMEs are most concentrated in agriculture, followed by the hospitality industry and the manufacturing industry. In manufacturing, SMEs are involved mainly in simple traditional products, such as wood products and furniture, textiles and garments, footwear, and food and beverages. Only a small portion of total SMEs produce machinery, production tools or automotive components. The latter is generally carried out through subcontracting arrangements with multinational car companies (Thee 1993 and Tambunan 2008). This structure of industry reflects the current technological capability of Indonesian SMEs, which are not yet as strong in producing sophisticated technology-embodied products as their counterparts in other economies such as Japan, the Republic of Korea, or Taiwan Province of China.

According to Statistics Indonesia (various years) the contribution of SMEs (including microenterprises) to annual gross domestic product (GDP) growth is higher than that of large enterprises. In 2003, the GDP growth rate was 4.78 per cent, of which 2.66 per cent was attributable to SMEs, compared to a contribution of 2.12 per cent from large enterprises. In 2005, the SME share in GDP growth reached its highest level—3.18 per cent—before slightly declining to 3.06 per cent in 2006. Within the SME group, the combined contribution of micro- and small enterprises to GDP growth is always higher than that of medium-sized enterprises. In 2006, of a GDP growth rate of 5.5 per cent, about 2.15 per cent was attributable to micro- and small enterprises, as compared to 0.91 per cent from medium-sized enterprises (figure 1). Unfortunately, no separate data on output are available for microenterprises. However, since the total number of such enterprises is much larger than that of small enterprises (see table 2), there is a strong reason to believe that the greater part of the contribution of micro- and small enterprises to the GDP growth, as shown in figure 1, came from microenterprises.

Figure 1. GDP growth contribution by size of firm, 2003-2006
(Percentage)



Source: Statistics Indonesia.

Table 2. Total units of enterprises by size category, Indonesia, 1997-2006
(Thousands of units)

Size category	*1997*	*1998*	*1999*	*2000*	*2001*	*2003*	*2004*	*2005*	*2006*
Micro-enterprises	36 528.3	33 085.5	35 158.2	36 131.7	35 894.8	40 336.8	41 109.7	42 306.2	44 428.8
Small enterprises	3 176.4	3 676.2	2 646.3	3 573.5	3 988.3	3 036.1	3 574.8	4 700.7	4 394.1
Medium-sized enterprises	60.5	51.9	51.8	78.8	81.0	87.4	93.0	95.9	106.7
Large enterprises	2.1	1.8	1.8	5.7	5.9	6.5	6.7	6.8	7.2
Total	39 767.3	36 815.4	37 858.1	39 789.7	39 970.0	43 466.8	44 784.1	47 109.6	48 936.8

Source: State Ministry of Cooperative and Small and Medium-sized Enterprises (Menegkop & UKM) database (available at www.depkop.go.id).

IV. INTERNATIONAL TRADE POLICY REFORM IN INDONESIA

When former Indonesian President Soeharto came to power in 1966, marking the beginning of the "New Order" Government (1966-1998), he initiated swift economic reform which, in its first five years, produced results beyond the most optimistic expectations. The main aim of the reform was two-pronged, namely, to reduce inflation (a short-term objective) and to generate economic growth and improve living standards (a medium- to a long-term objective). The Government was fully aware that macroeconomic stabilization was a precondition for achieving the first objective, and that international trade reform and liberalization of the capital account, including a more favourable investment law, were the most effective strategies for achieving the second.

During the New Order era, trade policy underwent a fundamental change in Indonesia. At the same time, development strategy evolved from the inward-looking import substitution approach of the oil boom in the early 1970s to an outward-looking policy of export promotion in the mid-1980s once the oil boom ended. The process of the trade reform that was part of the economic reform from 1966 to 2006 can be divided into three phases: 1967-1984, 1985-1997 (just before the economic crisis), and 1998 (during the crisis) onwards (table 3). The first phase was a period of limited liberalization and deregulation, as the Government implemented limited tariff reduction and removed quantitative restrictions and other non-tariff barriers on a small range of imported goods, particularly those which were essential for domestic consumption and industries.

Table 3. Reform in foreign trade and related areas in Indonesia since 1967

Period	*Phase*	*Most important measures*
1967 to 1984	I	• Some tariff reduction • Removal of quantitative restrictions on limited imports • Introduction of a national law on foreign and domestic private investment • Liberalization of the capital account in the balance of payments • Adoption of a managed floating exchange rate system
1985 to 1997	II	• Simplification of import-export procedures (including the duty drawback scheme for exporters, which was improved substantially) • Limited agricultural liberalization • Across-the-board tariff reduction • Removal of quantitative restrictions on some imports, especially import licensing and import monopolies

Table 3. *(continued)*

Period	*Phase*	*Most important measures*
		• Simplification of approval procedures for foreign investment and abolition of limitations on foreign direct investment, especially export-oriented investments (including more liberal treatment with regard to foreign ownership) • A revamping and replacement of the corrupt customs service with a private Swiss surveying company (Société Générale de Surveillance) • Exemption from duties and value added tax for export-oriented investments • Banking system deregulation
1998 onwards	III	• Liberalization of foreign trade and investment • Elimination of all cartels in all sectors • Agricultural liberalization, including actions such as: (a) removing import restrictions on various commodities; (b) removing export bans on wheat, soybeans, sugar and oil palm products; (c) replacing the monopoly role the State logistics agency (Bulog) played in rice imports with a 30 per cent tariff; (d) removing local content regulation for agricultural products; (e) privatizing plantations, estates and input suppliers; (f) liquidating cooperatives and removing land-use regulations that restricted crop choices of producers; (g) suspending the value added tax on rice and other essential commodities; (h) eliminating wheat, sugar and fertilizer subsidies; (i) phasing out soybean subsidies; (j) eliminating import subsidies and relevant import duties for soybean meal and fishmeal; and (k) allowing private traders to import rice, for the first time in 30 years • Removal of various import licensing schemes, such as the import licences for iron and steel products, engine and engine parts, heavy transport equipment, and electronic products • Removal of local content requirements, reduction of tariffs on imported cars and components, and simplification of licensing procedures • Elimination of all export restrictions and taxes • Introduction of anticorruption and competition laws • Approval of Importer and Approved Sole Agent licences, which were applied to various industries, from food-related products to lubricants • Removal of local content regulations under the World Trade Organization Agreement on Trade Related Investment Measures, as well as the local content requirements for motor vehicles

Source: Tambunan (2007b).

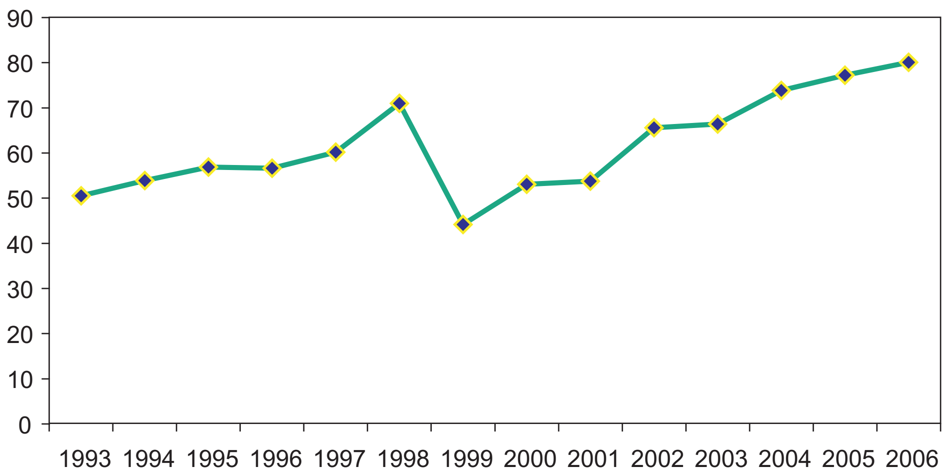
The second phase was a period of extensive liberalization and deregulation, with a broad range of measures. Between 1985 and 1992, the simple (unweighted) average tariff was cut to just under 20 per cent, down from 27 per cent. Non-tariff barriers as a percentage of tariff lines had declined from 32 down to 17 per cent by 1990 and to 5 per cent by 1992; as a percentage of imports they fell from 43 per cent in 1986 down to 13 per cent by 1990 (Iqbal and Rashid 2001). The private sector began to play a larger role during this period, as reflected by the increase in private domestic as well as foreign investments in Indonesia. There was also an emphasis on exports of non-oil and gas products, especially labour-intensive manufactured products, such as textiles and garments, footwear and wood products. Restrictions on foreign direct investment and ownership regulations, particularly on export-oriented investments, were gradually relaxed (Pangestu 2001).

The third phase is the broader post-crisis reform, which began with the International Monetary Fund-sponsored deregulation under a letter of intent and continued further with Indonesia's own initiatives. One of the most heavily regulated and protected sectors of the Indonesian economy, the automobile industry, was significantly affected by these developments. The tariff on completely built-up sedans was reduced to 200 per cent in 1995 and to 90 per cent in 2003.

Figure 2 shows the result of the foreign trade reform. The ratio of total trade (export plus import) to GDP increased steadily from the early 1990s up to

Figure 2. Growth in the external trade of Indonesia, 1993-2006

(Total trade as a percentage of gross domestic product)



Source: Asian Development Bank, Key Indicators database, (1993-2006).

1998, when the crisis reached its climax. That was also the year when many companies, especially in the manufacturing industry, experienced financial difficulties as a consequence of the huge depreciation of the rupiah (Rp) against the United States dollar. After 1999, Indonesia's external trade began to recover.

The bold reforms also resulted in rapid economic growth and an extremely rapid transformation from the beginning of the 1970s to 1997. High economic growth, together with low inflation, raised per capita income more than tenfold, from $70 in 1969 to $1,100 in 1997 (current prices). In 1998 the per capita income dropped significantly, but in 2000 it started to recover, though the process has been slow. The growth rate of per capita real GDP is still much lower than that of Thailand, another country seriously affected by the 1997 crisis. Growth during the New Order era was matched by similar success on the income distribution side. The number of people living below the poverty line was reduced from 70 million in 1970 to 26 million in 1993. This meant that the percentage of people living below the poverty line dropped to 14 per cent, down from 60 per cent.[5]

V. EFFECTS OF THE REFORM ON SMEs IN INDONESIA

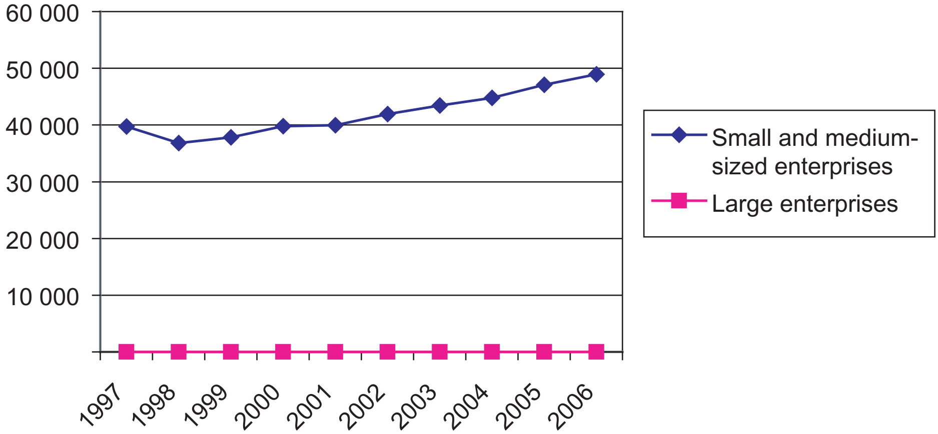
The rapid growth of the manufacturing industry and non-oil and gas exports in Indonesia before the 1997 crisis was an important success attributable to the trade policy reforms, which were accompanied by reforms in other important related areas, such as the investment and banking sector. However, there are always concerns regarding the survival of SMEs in the country. On the import side, can local SMEs survive if imports are allowed to freely enter the domestic market? On the export side, have export opportunities been more open for local SMEs since the reform? Has the growth of exports by SMEs accelerated since the reform?

With respect to the first question, after a slight decline in 1998 (many SMEs were adversely affected by the crisis), the number of SMEs continued to grow (figure 3). Of course, many SMEs in Indonesia must have difficulties in facing the stiff competition from the imports in the domestic market that is growing as a direct consequence of the trade policy reform. But figure 3 may suggest that SMEs in Indonesia in general have not been severely affected by trade liberalization. More interestingly, the number of SMEs tends to grow faster than that of large enterprises.

Moreover, the GDP share of SMEs remains above 50 per cent; in other words, the ratio of SMEs to large enterprises in GDP contribution is always above one, although it has been declining since its peak level in 2002 (figure 4). If the

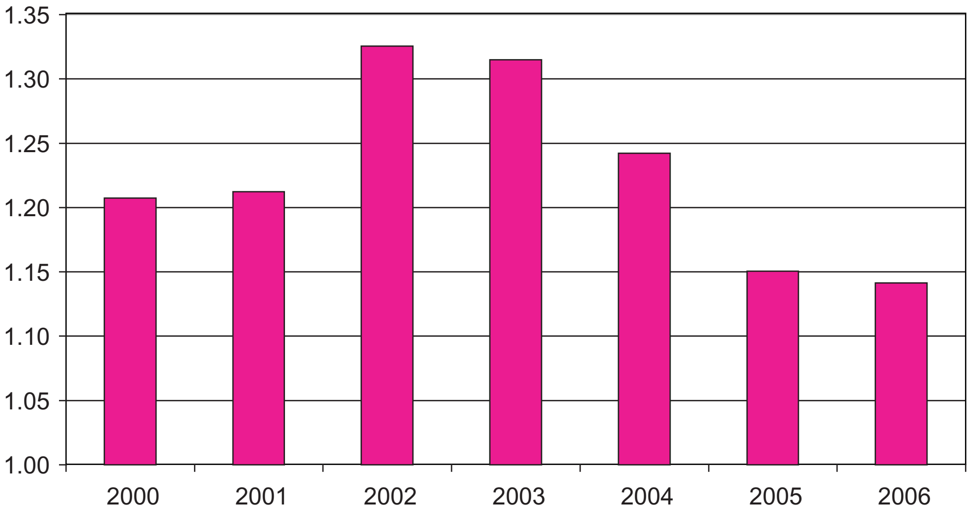
5 The remarkable economic development in Indonesia during the New Order Government is discussed in many publications, including: Booth and McCawley (1981), Hill (1996) and Tambunan (2006b).

Figure 3. Growth in the number of small and medium-sized enterprises (excluding microenterprises) and large enterprises, 1997-2006



Source: State Ministry of Cooperative and Small and Medium-sized Enterprises (Menegkop & UKM) database (www.depkop.go.id).

Figure 4. Ratio of small and medium-sized enterprises to large enterprises in terms of gross domestic product contribution, 2000-2006



Source: State Ministry of Cooperative and Small and Medium-sized Enterprises (Menegkop & UKM) database (www.depkop.go.id).

Note: The data on small and medium-sized enterprises include microenterprises (no separate data are available for microenterprises).

reforms before and after the crisis favoured large enterprises, the share of SME contribution to GDP would have fallen to less than 50 per cent. SMEs have managed not only to survive, but also to increase their output. There is thus no evidence to support the suspected negative correlation between the openness of the Indonesian economy that resulted from the trade reforms and the existence of local SMEs.

With respect to the second and third questions, not only are SMEs able to export, but their exports increase on average per year. In 2000, their total exports amounted to Rp 75,449 billion; by 2006, exports had increased by 50 per cent to Rp 122,200 billion (table 4). However, the share of SMEs in the country's total exports (excluding oil and gas) is still very small as compared to that of large enterprises. In 1990, their share was 11.1 per cent; by 2006 it was 15.7 per cent. Medium-sized enterprises are much stronger in exports than small enterprises are. In 1990, medium-sized enterprises accounted for 8.9 per cent of total exports, compared with 2.2 per cent for small enterprise. In 2006 the ratio was 11.81 to 3.89 per cent (figure 5).

The majority of SME exports came from the manufacturing industry. However, the share of SMEs in total exports of the manufacturing industry continues to be smaller than that of large enterprises (figure 6). Many, such as Hill (1997), Tambunan (2006a and 2007a) and Thee (1993) argue that, although on average their annual export contribution to Indonesia's total manufacturing export is relatively small, SMEs seem to have shared in the manufactured export boom in the 1980s and 1990s. Thee (1993) concludes that, from the point of view of technology and adaptability, export growth of SMEs in the manufacturing industry has been achieved largely by finding niche markets and adapting costs and quality to market demand.

Perhaps the only microlevel evidence of the effects of trade reform in Indonesia on SME exports is from a field study conducted by Berry and Levy (1994). They surveyed 91 SME exporters in three subsectors of manufacturing, and conducted intensive interviews with 40 public and non-profit agencies active in SME issues between January and June 1992. The three subsectors were: garments in Jakarta and Bandung (both in West Java), rattan furniture in Jakarta and Surabaya (East Java) and carved wooden furniture in Jepara (Central Java). From a total of 33 interviewed exporters of rattan products, they found that all but one of the firms exported 90 per cent or more of their output; 26 of 33 firms began exporting the same year they entered into production. Most began to export or increased their export share in their total production since the Government of Indonesia imposed bans on the export of unprocessed and semi-processed rattan

Table 4. Exports of small and medium-sized enterprises and large enterprises in three major sectors, 2000-2006

(Billions of Indonesian rupiah)

Sectors	*2000*		*2001*		*2002*		*2003*		*2004*		*2005*		*2006*	
	SME	*LE*	*SME*	*LE*	*SME*	*LE*	*SME*	*LE*	*SME*	*LE*	*SME*	*LE*	*SME*	*LE*
Agriculture	8 396.3	427.5	9 013.6	552.7	9 771.6	962.2	8 479.7	536.6	8 715.3	881.8	11 535.4	1 037.9	12 662.7	1 078.8
Mining	657.0	74 490.8	980.9	89 811.2	684.7	79 541.5	583.9	77 829.2	638.7	92 822.5	1 139.9	132 107.3	1 621.3	153 874.3
Manufacturing	66 395.3	357 135.5	70 852.1	377 040.4	76 833.8	339 086.3	68 033.1	337 773.4	86 194.2	414 953.7	97 662.7	471 249.3	107 915.5	501 170.5
Total	75 448.6	432 053.8	80 846.6	467 404.3	87 290.1	419 590.0	77 096.7	416 139.2	95 548.2	508 658.0	110 338.0	604 394.5	122 199.5	656 123.6

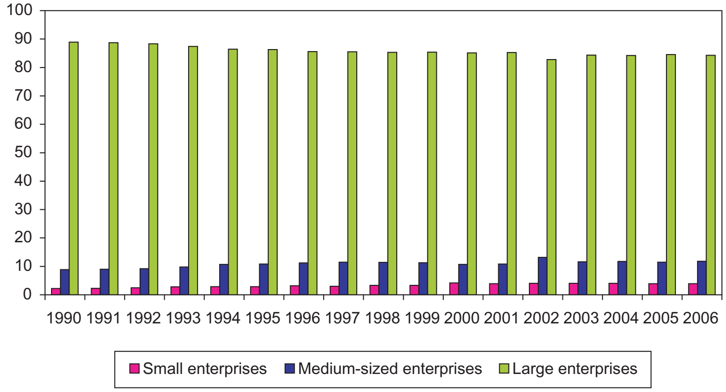
Source: State Ministry of Cooperative and SME (Menegkop & UKM) database (www.depkop.go.id).

Note: The data on small and medium-sized enterprises include microenterprises (no separate data are available for microenterprises).

Abbreviations: LE, large enterprises; SME, small and medium-sized enterprises.

Figure 5. Contributions of small and medium-sized enterprises to total export value, 2000-2006

(Percentage)

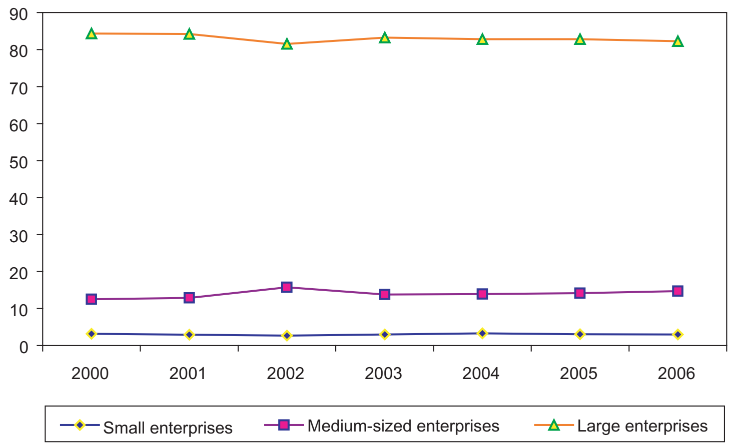


Source: *State Ministry of Cooperative and Small and Medium-sized Enterprises (Menegkop & UKM) database (www.depkop.go.id).*

Note: *The data on small and medium-sized enterprises include microenterprises (no separate data are available for microenterprises).*

Figure 6. Share of small and medium-sized enterprises in total export value in the manufacturing industry, 2000-2006

(Percentage)



Source: State Ministry of Cooperative and Small and Medium-sized Enterprises (Menegkop & UKM) database (www.depkop.go.id).

Note: The data on small and medium-sized enterprises include microenterprises (no separate data are available for microenterprises).

in 1986 and 1988-1989. This suggests that the ban has been a key factor leading to a major expansion in exports of rattan furniture by SMEs in Indonesia.[6]

The view expressed by Berry and Levy (1994) is also supported by the author's own observations that free exports of raw materials have become serious constraints for many SMEs that produce or export goods made from such materials. For instance, several times during the 1980s and also in the 1990s, many SMEs in metalworking industry clusters, for example in Tegal and Ceper in Central Java and Pasuruan in East Java, experienced difficulties in continuing or expanding their production due to the lack of local scraps—their main raw material. This material has been exported mainly to China, leading to a scarcity in the local market.[7] In another case, PT Panasonic Manufacturing Indonesia, the leading electronic company in Indonesia, has subcontracting linkages with many SMEs to manufacture a variety of electronic products. Recently, subcontractors that make water pumps for the company have been facing difficulties due to a scarcity of one of their main raw materials—brass, which is one of the raw materials that are free for export.[8]

Shortly after the economic crisis in 1997, Dierman and others (1998) tried to assess the impact of the more aggressive trade and investment policy reforms related to the International Monetary Fund-sponsored deregulation on SMEs in the manufacturing industry in Indonesia. They concluded that the likely impact would vary by subsector or group of industry. SMEs in the industries that were most protected before the crisis were expected to be more adversely affected than those in the less protected ones. For instance, currently many SMEs in the textile and garment industry, one of the most protected industries before the crisis, are struggling to compete with very cheap textile products from China, which have been extensively penetrating the Indonesian market over the past few years.

Overall, based on the official data presented in the present paper and several studies, including that of Van Dierman and others (1998), there is no indication that the number of SMEs, including microenterprises, in Indonesia has been negatively affected by the international trade reform (figure 7). Moreover, relying on protection that restricts certain activities to domestic SMEs may actually

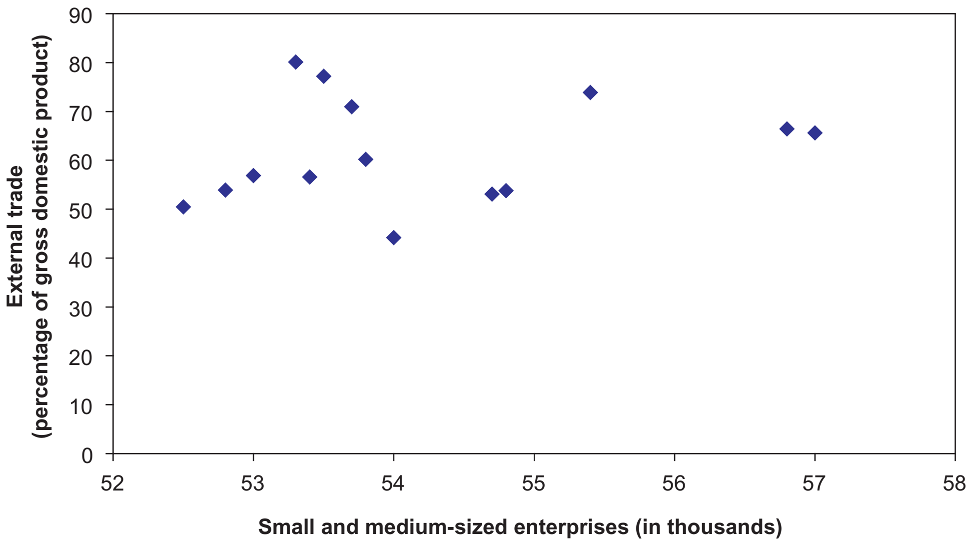
[6] Indonesia has long been a major supplier of raw rattan to the major rattan furniture exporting areas of Taiwan Province of China and the Philippines. In an effort to jump-start the rattan products industry in the country, the Government of Indonesia imposed this restriction policy (Berry and Levy 1994).

[7] Interviews by the author with some producers and local government officials in the Tegal cluster, February 2007.

[8] Interview by the author with Daniel Suhardiman, Group Manager from PT Panasonic Manufacturing Indonesia.

contribute to abuse of local market power and, by insulating firms from competition, make them less able to penetrate foreign markets or develop improvements in technology, productivity and efficiency (Thee 2000). However, there is also no evidence that the efficiency effects of trade liberalization resulted in an increase in average plant size among SMEs. This Indonesian case seems to be consistent with the findings by Tybout (2000) that trade liberalization may work against the (scale) efficiency of SMEs in the short run.

Figure 7. Scatter diagram of the number of small and medium-sized enterprises (including microenterprises) and trade in Indonesia



Sources: State Ministry of Cooperative and Small and Medium-sized Enterprises (Menegkop & UKM) Perkembangan Indikator Makro UKM database, Table 1 (www.depkop.go.id), and Statistics Indonesia data for Indonesian external trade and gross domestic profit.

As microenterprises represent the informal sector in Indonesia, it can also be concluded that the informal sector has managed to survive the processes of trade liberalization. There are two main reasons for this. First, although imported goods, especially from China, have been penetrating the domestic market at an accelerating rate in the period, such goods are still concentrated in urban areas or cities, while microenterprises are still the dominant source of basic consumption goods in rural areas. Second, in general, imported goods are still more expensive than those produced by the microenterprises on which most poor or low-income households are dependent.

As a comparison, in India as well as in China and other ASEAN countries with more or less similar stages of development, SMEs have also been playing an important role in exports, directly or indirectly (through subcontracting arrangements with large enterprises, including multinational companies), although the rate varies by country. As can be seen in table 5, among the surveyed countries, SMEs in China play the largest role, with export contributions running between 40 and 60 per cent. SMEs in Thailand, which is more comparable to Indonesia in terms of level of economic development, are more developed in export activities than their counterparts in Indonesia (figure 8).

Table 5. Share of small and medium-sized exports in total exports in selected Asian developing countries, 1990s

Country	*2003 Share (percentage)*	*2005-2006 Share (percentage)*
China	40 to 60[a]	..
Indonesia	11[a]	17.72 (2006)[b]
India	38 to 40[c]	..
Malaysia	15[a]	..
Pakistan	..	25 (2005)[d]
Singapore	16[a]	..
Thailand	10[a]	29.10% (2006)[e]
Viet Nam	20[a]	..

Sources: [a] United Nations Conference on Trade and Development (2003), for manufactured export only.

[b] State Ministry of Cooperative and SME (Menegkop & UKM) database (www.depkop.go.id).

[c] United Nations Conference on Trade and Development (2003), ICICI Bank and International Finance Corporation (2002), and Das (2007), for manufactured export only.

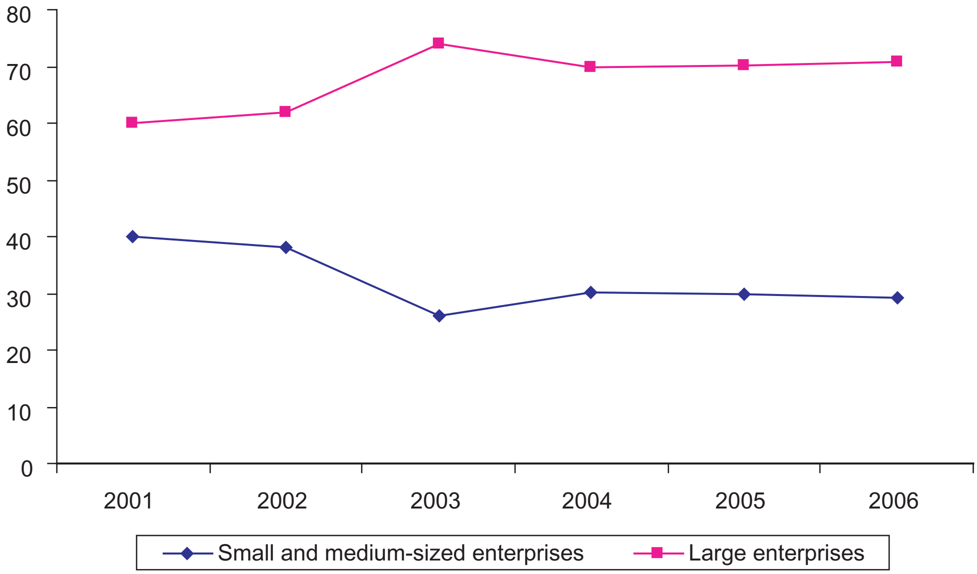
[d] Tambunan (2008).

[e] Thailand (2007).

All this evidence may suggest that trade openness does not negatively affect local SMEs. But neither does it automatically lead local SMEs to become exporters or increase their external market shares. It depends, among many other things, on the role of government in supporting capacity-building for local SMEs so that they can become highly competitive exporters. In other words, trade liberalization creates export market opportunities only for efficient and highly competitive local SMEs.

Figure 8. Export share of small and medium-sized enterprises in Thailand, 2001-2006

(Percentage)



Source: Thailand, Office of Small and Medium Enterprises Promotion (as cited in Tambunan 2008).

VI. CONCLUDING REMARKS AND POLICY RECOMMENDATIONS

The rapid economic growth and rapid transformation of the Indonesian economy in the New Order era may be due largely to the combination of reforms in trade and other related areas, such as investment and banking, undertaken during that period. After the economic crisis in 1997-1998, more aggressive reforms also started to show some results, as the country's GDP began growing again in 1999 and it has kept growing at an accelerating rate.

In the present paper, two main questions were posited: (a) how does international trade policy reform affect local SMEs?; and (b) has the growth of SME exports accelerated since the reform? The official data presented in the paper suggest that, overall, the reform has not affected SMEs negatively. However, the majority of SMEs (especially small and microenterprises) in Indonesia are not yet ready to compete due to their weaknesses in many areas, including, among others: technology, human resources, capital, marketing knowledge and global networks.

Therefore, the Government should take concrete actions in order to help SMEs maximize benefits and minimize losses related to the trade reform over the long run. This policy implication is also valid for many other Asian developing countries, where conditions for SMEs are similar to those in Indonesia.

The required policy actions are particularly related to the following aspects. First, trade liberalization should be accompanied by development schemes designed to support long-term capacity-building for SMEs; such schemes should focus on six major areas: (a) credit and market information; (b) human resource development; (c) technology and innovation; (d) global networks in both input and output markets; (e) subcontracting opportunities and capabilities; and (f) infrastructure that increases access for local SMEs to broader markets. Second, trade reform policies should be carefully designed to prevent the liberalization of exports of unprocessed commodities which are the key raw materials for SMEs, as such liberalization could lead to shortages of these items in the local market and reduce the production capacity of SMEs. Third, new plans with respect to trade regulations should be disseminated to all SMEs through all available channels (such as electronic media, newspapers, press releases and public gatherings) in advance of their implementation. At the same time, the Government should provide SMEs with effective alternative solutions in order to minimize the negative effects or maximize the positive effects of such new policies or regulations. Fourth, SMEs represented by, among other entities, SME associations or non-governmental organizations, should be more actively involved in the preparation and formulation of economic policies (such as in trade and investment) that will affect them directly or indirectly.

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