STUDIES IN TRADE AND INVESTMENT
65

Globalization of Production and the Competitiveness of Small and Medium-sized Enterprises in Asia and the Pacific: Trends and Prospects

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ECONOMIC AND SOCIAL COMMISSION FOR ASIA AND THE PACIFIC

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PREFACE

This publication was prepared by the Trade and Investment Division of ESCAP. Its principal aim is to fill a perceived gap in policy-related research and understanding of the development of the small and medium-sized enterprise (SME) sector in the Asia-Pacific region, in the context of a rapidly changing and mutating international business environment.

To foster growing national economies, policymakers in virtually all countries are expected to facilitate the entry of new business ventures and to increase the competitiveness of SMEs. SMEs typically account for the vast majority of companies in an economy, create the majority of employment, and are responsible for a substantial number of technical innovations in various sectors. Thus, their growth and survival are critical for sustainable and inclusive socio-economic development under intensified global competition.

Although considerable research has already been undertaken in this broad field, many developing countries in Asia and the Pacific lack a comprehensive understanding of the rapidly changing needs of the business sector—a result of the ongoing globalization of production—and how such needs should be taken into account in the design and implementation of effective enabling policy frameworks for SME development. This paper attempts to fill that lacuna.

This paper was penned in the latter part of 2008, when the global "credit crunch" and its wider impact on the global economy were becoming more readily apparent. The likely consequences in 2009 and beyond will only add to the challenges faced by SMEs—and policymakers seeking to support the SME sector—in an increasingly volatile international business environment. In particular, the business risks associated with uncertainty have risen considerably.

However, the current global economic recession should not derail ongoing efforts to support SME development, as those businesses provide part of the solution to the current economic woes. SME development is a key ingredient in the policy mix that will allow international business to return to healthy growth and permit Asia-Pacific economies to return to robust and inclusive growth.

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Use of a hyphen between dates (e.g. 1980-1985) indicates the full period involved, including the beginning and end years.

The following symbols have been used in the tables throughout the publication:

A hyphen (-) indicates that the item is not applicable.

A point (.) is used to indicate decimals.

A space is used to distinguish thousands and millions.

Totals may not add precisely because of rounding.

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ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
BDS	business development services
ESCAP	United Nations Economic and Social Commission for Asia and the Pacific
FDI	foreign direct investment
GDP	gross domestic product
GVC	global value chain
ICT	information and communications technology
IPN	international production network
ISO	International Organization for Standardization
MNE	multinational enterprise
OECD	Organization for Economic Cooperation and Development
OEM	original equipment manufacturer
QS	quality system
SA	social accountability
SMEs	small and medium-sized enterprises (including microenterprises)
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

The Asia and Pacific region has achieved unprecedented growth and development in recent decades. Asia is increasingly playing the role of a global growth pole, and fast emerging as a manufacturing and information technology hub of the world economy, yet more than 600 million people in the region still live in absolute poverty. China and India are reshaping international business and the global economy, partly through the operations of internationally competitive enterprises such as Lenovo and Infosys. Nevertheless, they coexist with far greater numbers of traditional, local micro-, small and medium-sized enterprises (SMEs). Those smaller enterprises, confronted with the perennial challenges of gaining access to finance, technology, human resources and market information, must also adjust to the new opportunities and threats posed by globalization.

This paper focuses on a key dynamic that is changing the business environment: the globalization of production, which has major implications for the growth prospects of SMEs in Asia and the Pacific. The current global economic environment is characterized by trade liberalization, rapidly changing technology, and growing and ever-mutating demand for higher-quality and differentiated intermediate and final products and services that must meet increasingly stringent international standards. Traditional SMEs find it difficult to stay competitive in such an environment, even in their domestic markets. Conversely, by facilitating linkages with foreign buyers and large multinational enterprises, the forces of globalization loosen the constraints of domestic economies and markets, and provide local SMEs with potential access to globally distributed assets, including information, technology, skills, capital and markets.

So how can Asia-Pacific SMEs, policymakers and development partners seek to mitigate the challenges posed by the former trend by optimizing the latter trend? This paper seeks to provide some policy-oriented recommendations and practical initiatives that the authors believe would be of use. These include: (a) implementing a number of focused improvements to the (external) business enabling environments for SMEs, with particular emphasis on logistics systems; (b) carrying out multiple efforts to improve the sophistication of (internal) operations and business strategies of SMEs; (c) developing and supporting more enterprise “clusters”; and (d) pursuing a number of subregional cooperative actions. The paper concludes with a suggested action plan, comprising 10 specific components, designed to assist the burgeoning community of SMEs in Asia and the Pacific to become more competitive, and thereby harness the globalization of production trend to best effect.

1

SMEs IN ASIA AND THE PACIFIC

Asia and the Pacific is a region of contrasts. The region as a whole has achieved unprecedented growth and development in recent decades. The general picture, however, hides a great diversity of economies, development experiences, and challenges. Asia is increasingly playing the role of a global growth pole, and is fast emerging as a manufacturing and information technology hub of the world economy. Yet the World Bank estimates that more than 900 million people still live in extreme poverty, now defined as less than $1.25 a day. Asia is the home of China and India—giants that are reshaping international business and the global economy through, among other things, the operations of internationally competitive enterprises such as Lenovo (China) and Infosys (India); but such giants also coexist with a large number of traditional, local micro- and small enterprises. In addition, China and India share this vast continent with Bhutan, Nepal and the Lao People's Democratic Republic, all considered least developed countries, and the region includes the small island nations of the Pacific, whose prospects for development also remain far more limited.

One characteristic of this vast and diverse region is the presence and importance of a large SME sector comprising the majority of enterprises in all the region's economies. Given the region's diversity, enterprises in general, and SMEs in particular, are at different stages of evolution in their respective economies; their relative roles and contributions also differ. Thus, the constraints they face and the corresponding policies aimed at strengthening their competitive performance are expected to vary. Nevertheless, there are also basic similarities in the broad challenges faced by SMEs in the region, for example in terms of access to finance, technology, human resources, market information and, above all, in adjusting to both the opportunities and threats of globalization.

1.1. Definitions and profiles

> *SMEs are a source of employment, competition, economic dynamism, and innovation; they stimulate the entrepreneurial spirit and the diffusion of skills. Because they enjoy a wider geographical presence than big companies, SMEs also contribute to better income distribution.*
>
> *Supachai Panitchpakdi, Secretary-General of the United Nations Conference on Trade and Development (Panitchpakdi 2006)*

Most people have a broad sense of what constitutes an SME, if only a rather stereotypical image of a young and relatively fragile business. In many cases, that stereotype indeed holds true. Like any stereotype, however, it is neither the full picture nor universally correct. There is a temptation to liken SMEs to the student generation of the corporate community, containing considerable growth potential, if only their energy and enthusiasm can be harnessed and channelled in the right direction. Pushing the analogy

further, some SMEs will go on to great things in later life, while most will probably achieve more modest goals, and sadly some will come to a premature end for one reason or another.

Most policymakers and development practitioners deem the health of the SME community to be highly important for an economy, whether subnational, national or regional. Not only do SMEs typically constitute the vast majority of company registrations in any economy, there is also the expectation that an elite few will make the leap "from garage to great". The likes of Microsoft and Apple Inc. serve as living proof that the "American Dream" of SME development is no fantasy; it can be done, given the right set of factors and conditions. Here in Asia, Infosys of India was started with capital of just $250, but has risen to become a business with revenues of $4 billion, and is listed on NASDAQ in the United States of America.

Similarly, the bursting of the "dot.com" bubble in 2001 provides evidence that perils also abound for new SMEs that seek to pursue unviable business models (and for the investors that inject equity capital into them). There can be value destruction as well as value creation.

The main ingredients that make up factors and conditions conducive for SME sector development are increasingly well known and understood by policymakers and economic practitioners. Some of the fundamental ingredients of a benign enabling environment for SMEs are perennial in nature and will always hold true, particularly at the start-up stage. But it must also be recognized that SMEs do not operate in splendid isolation, and are not divorced from a constantly changing global business environment. The factors that made "SME X" successful in country A may not pertain to "SME Y" in country B. Similarly, the conditions that made "SME A" successful in "199X" may not pertain to "SME B" in "200Y". Some of the pro-SME policy formulas are fairly generic and constant, and some are more specific and ever-changing. Just as SMEs themselves have to keep up-to-date with changing business practices (and technologies) if they want to remain commercially successful, so too must policymakers and development agencies ensure that their pro-SME prescriptions are contemporary, if they want their strategies to remain relevant and useful.

For developing and transitional economies in particular, SME development holds the added allure of being a key component of wider economic development and poverty alleviation. The SME community is seen as a major and sustainable generator of employment and income (and therefore tax revenues) for citizens working outside of the State sector. In the case of transitional economies, although many State-owned enterprises can also be SMEs, SME development is broadly synonymous with private sector development. In developing countries, SMEs can also serve as a useful bridge between the informal economy of family enterprise and the formalized corporate sector. Some of a country's more able SMEs may also be a source of foreign exchange earnings, if they are able to meet the quality and quantity standards required to export their products or services overseas.

There is also a tendency to believe that a vibrant SME sector helps promote competition and a culture of entrepreneurship, which are both conducive for economic growth. Further, SMEs are often seen as being nimble and agile, and more willing to innovate than their larger and more well-established peers, as they navigate the frontiers of business activity. Youth versus experience. David versus Goliath. This is particularly

true of entrepreneur-driven SMEs, typically seeking to exploit business opportunities, as they can "… drive structural transformation [of an economy and corporate sector] through innovation, provision of intermediate inputs and services (which permits greater specialization in manufacturing), and by increasing employment and productivity …" (Gries and Naudé 2008a, 1). Thus, some of the more innovative and dynamic SMEs can serve as catalysts in transforming developing economies in various structural ways, including advances up the value chain. The economic transformation of Taiwan Province of China is often viewed in this context.

It is important, however, to recognize that as yet there is no hard empirical evidence to support the assertion that the presence of SMEs in an economy will automatically deliver economic growth, nor alleviate poverty or lessen income inequality.[1] SMEs are not a magic bullet for poverty alleviation, and they are not specifically pro-poor, contrary to popular belief. Rather, a more modest claim can be made, namely that the size of the SME sector in an economy does appear to be positively *associated* (if not quite correlated) with gross domestic product (GDP) per capita growth in many countries. Strong SME sectors do not necessarily drive economic growth, but they are "characteristic of fast-growing economies" (Gries and Naudé 2008a, 1). That said, there is clear recognition of the importance of SMEs in job creation—a key dimension of the development process, particularly in the lagging economies of Asia and the Pacific.

1.1.1. What exactly is an SME ?

Definitions of what constitutes an SME vary quite widely from country to country and even within single countries, depending on the business sector concerned.[2] Thus, there is no universal determinant or criteria of an SME. Much depends on the character of the relevant host country, and the profile of its own particular corporate sector, from which a relative measure of an SME is then typically made, sometimes on a rather arbitrary basis. Some countries just use the number of employees as the sole criteria for determining whether a business is an SME or not. Other countries use this same criterion, plus an additional criterion based on either the value of the firm's assets or the size of revenues, typically denominated in the local currency.[3] In cases where a currency value is cited (either for assets or revenues), any marked inflation can pose a problem for the SME definition over time. The criteria for SMEs are updated in some countries from time to time.

The form of ownership profile, type of legal entity, or general provenance of the company are typically deemed irrelevant when creating the definition. Thus, while an SME is typically thought of as a locally owned and privately held business, there is no reason why it may not be a State-owned or foreign-invested enterprise. Some countries will distinguish between a microenterprise and a small enterprise, while others—by not setting a floor for SME size—effectively include microenterprises within their SME umbrella definition (this is the case in Viet Nam). The above notwithstanding, most SME definitions pertain to businesses that are formal in nature and have been registered in some manner, and exclude small-scale, informal family enterprises.

[1] See Beck, Demirguc-Kunt and Levine (2005). As the number of SMEs rise, one should not expect the Gini coefficient to automatically go down.

[2] The Government of Malaysia provides a good example of this multisector breakdown of the SME definition. See its "Definitions for small and medium sized enterprises in Malaysia", September 2005.

[3] Cambodia is a notable exception, in that its definition uses United States dollars, not the riel, as the currency of measure.

Table 1 serves to give a sense of the diversity of SME definitions in the Asia-Pacific region alone; table 2 provides the European Union definition for comparison.

Table 1. Some differing definitions of SMEs in South-East Asia

Country	Definition
Cambodia	Firms that employ between 11 and 50 employees and have fixed assets of $50,000 to $250,000 are categorized as small. Firms with 51-200 employees and fixed assets of $250,000 to $500,000 are medium-sized. Source: SME Development Framework of 2005.
Indonesia	Fewer than 100 employees.[a]
Lao People's Democratic Republic	"Small enterprises are those having an annual average number of employees not exceeding 19 persons or total assets not exceeding two hundred and fifty million kip or an annual turnover not exceeding four hundred million kip". "Medium sized enterprises are those having an annual average number of employees not exceeding 99 persons or total assets not exceeding one billion two hundred million kip or an annual turnover not exceeding one 1 billion kip".
Malaysia	Depends on the business sector. Different criteria, based on the number of employees and annual sales turnover. For details, see www.smeinfo.com.my/pdf/sme_definitions_ENGLISH.pdf.
Philippines	Fewer than 200 employees, and less than P 40 million in assets.[a]
Thailand	Depends on the business sector. Different criteria, based on number of employees and fixed capital size. For details see http://cms.sme.go.th/cms/web/homeeng.
Viet Nam	SMEs are independent production and business establishments that are duly registered according to the current law provisions, each with registered capital not exceeding VND 10 billion or annual labour not exceeding 300 people.

Sources: Cambodia, *SME Development Framework of 2005* (Ministry of Industry, Mines and Energy).

Lao People's Democratic Republic, Decree 42/PM on the Promotion and Development of Small and Medium Sized Enterprises (Vientiane, 2004), art. 2.

Malaysia, *Definitions for Small and Medium Enterprises in Malaysia* (Secretariat to National SME Development Council and Bank Negara Malaysia, 2005), available at www.smeinfo.com.my/pdf/sme_definitions_ENGLISH.pdf.

Viet Nam, Decree on Support for Development of Small- and Medium-sized Enterprises (Hanoi, Ministry of Planning and Investment, 2001), chap. 1, art. 3

[a] As cited in the Small and Medium Enterprise Development Authority (Pakistan) website (www.smeda.org.pk/main.php?id=2).

Perhaps the one common denominator is that SMEs typically make up more than 90 per cent of all registered enterprises in any country. Thus, in terms of the number of incorporations at least—if not always in terms of aggregate asset size or cumulative productivity—SMEs tend to dominate the corporate community. Economies differ, however, in the extent to which they rely on SMEs to generate a greater or lesser proportion of total output.

Table 2. Just for comparison: the European Union definition of an SME

Enterprise category	Headcount	Turnover (in euros)	Balance sheet total (in euros)
Medium-sized	< 250	≤ 50 million	≤ 43 million
Small	< 50	≤ 10 million	≤ 10 million
Micro	< 10	≤ 2 million	≤ 2 million

Source: European Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, available at http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm.

1.1.2. SMEs in Asia and the Pacific: a profile of the corporate landscape

As noted earlier, SMEs tend to dominate the corporate community in all countries, at least in terms of company registrations, if not always in terms of aggregate size. In less developed countries, for example Cambodia, the Lao People's Democratic Republic and Nepal, SMEs represent the vast bulk of the corporate sector. And even at the other end of the economic spectrum in Asia, in Japan for example, SMEs account for about 99 per cent of all firms, 70 per cent of total employment and 50 per cent of GDP output. SMEs play an important economic role in virtually all countries, albeit to varying degrees, and it is their relationship with other elements of the corporate community—including foreign-invested enterprises and large domestic corporations (whether State-owned or private)—that is often a critical determinant of their long-term success. Mutually beneficial linkages are typically established between these various elements of the corporate community.

This is not a static arrangement. Rather, it is a fluid set of relationships that mutate over time, as individual SMEs and other business organizations inevitably wax and wane. This is particularly true of SMEs that are driven by entrepreneurs, typically seeking to exploit an opportunity that they have perceived to exist. And it is the "innovative tension" that arises which drives an economy forward; hence the crucial importance of property rights (including intellectual property rights). In the context of developing and less developed economies, Gries and Naudé (2008a), in the context of an endogenous growth model they developed, depict the role played by entrepreneur-driven SMEs in advancing an economy thus:

> In essence the transformation from a low-income, traditional economy to a modern economy … involves significant changes to production methods, a process of change where … entrepreneurs provide essential roles: first, in creating new firms outside of the household, second by absorbing surplus labour from the traditional sector, third by providing innovative intermediate inputs to final-goods producing

> firms, fourth by permitting greater specialization in manufacturing, and fifth by raising productivity and employment in both the modern and traditional sectors. (Gries and Naudé 2008a, 25)

This is not to dismiss the crucial role played by foreign-invested enterprises, and large domestic firms too, in advancing a developing economy. But it does recognize the important role played by more innovative SMEs, and acknowledges that they are not passive spectators sitting on the sidelines of an economic development exercise from which they are largely divorced.

However, the ability of more innovative SMEs to perform this economic function is significantly determined by the business environment in which they are obliged to operate. Without conducive conditions—the right kind of business enabling environment—in which to develop and grow, SMEs are likely to remain: (a) bonsai-like in stature; and (b) much less dynamic in their actions. This explains in large part why attention is often placed on various global indices and indicators that attempt to measure and compare the business environments in different countries. The better indices have a genuine benefit in identifying issues and comparing them across countries, as a basic form of diagnostic analysis.

1.1.3. Enabling environments for SMEs in the Asia-Pacific region

Although not specific to the SME sector, the World Bank's annual Doing Business rankings comprise perhaps the most comprehensive survey of economies (181 in the latest iteration) and their differing business conditions. Briefly, the Doing Business exercise seeks to quantify and rate the ease of doing business in a country, based on 10 components, comprising: (a) starting a business; (b) dealing with construction permits; (c) employing workers; (d) registering property; (e) getting credit; (f) protecting investors; (g) paying taxes; (h) trading across borders; (i) enforcing contracts; and (j) closing a business. Although there is some debate as to the methodological approach used for this exercise, the findings are useful in indicative terms and in spotlighting where a country's main areas of strength and weakness lie, in terms of doing business. Table 3 shows the aggregate *Doing Business 2009* rankings for Asia-Pacific economies covered.

Table 3. *Doing Business 2009:* aggregate rankings for Asia-Pacific economies

Economy	Rank	Economy	Rank
Singapore	1	Brunei	88
New Zealand	2	Solomon Islands	89
Hong Kong, China	4	Palau	91
Australia	9	Viet Nam	92
Japan	12	Marshall Islands	93
Thailand	13	Papua New Guinea	95
Malaysia	20	Sri Lanka	102
Republic of Korea	23	Bangladesh	110
Azerbaijan	33	Nepal	121
Fiji	39	India	122
Mongolia	58	Bhutan	124
Vanuatu	60	Micronesia (Federated States of)	126
Taiwan Province of China	61	Indonesia	129
Samoa	64	Cambodia	135
Kyrgyzstan	68	Uzbekistan	138
Maldives	69	Philippines	140
Kazakhstan	70	Tajikistan	159
Pakistan	77	Afghanistan	162
Kiribati	79	Lao People's Democratic Republic	165
China	83	Timor-Leste	170

Source: World Bank, *Doing Business 2009* (Washington D.C., 2009).

A similar exercise of sorts is conducted by the Fraser Institute's Economic Freedom of the World Exercise, which has been running for over 20 years and now spans 141 economies. Essentially it is an index that seeks to measure economic freedom in an economy across five principal components, most of which are pertinent to SMEs and the business sector as a whole.[4] The latest report, published in 2008, analyses data for 2006, and ranks Asia-Pacific economies as shown in table 4.

[4] The five components are: (a) size of government; (b) legal structure and security of property rights; (c) access to sound money; (d) freedom to trade internationally; and (e) regulation of credit, labour and business.

Table 4. Economic freedom: rankings for Asia-Pacific economies

Economy	Rank	Economy	Rank
Hong Kong, China	1	India	77
Singapore	2	Fiji	83
New Zealand	3	Papua New Guinea	87
Australia	8	China	93
Taiwan Province of China	18	Indonesia	101
Japan	27	Sri Lanka	103
Republic of Korea	29	Pakistan	104
Kazakhstan	42	Bangladesh	108 (joint)
Mongolia	43	Viet Nam	108 (joint)
Thailand	56	Azerbaijan	118
Kyrgyzstan	60	Nepal	128
Malaysia	72	Myanmar	139
Philippines	73		

Source: James Gwartney and Robert Lawson, with the assistance of Joshua Hall, *Economic Freedom of the World: 2008 Annual Report* (Economic Freedom Network, 2008).

While not all of the elements within this particular index's five components are entirely pertinent to SME sector development, some very much are, including (but not limited to):

(a) the size of government in business (which relates to "crowding out" issues);

(b) property rights protection;

(c) legal enforcement of contracts;

(d) freedom to hold foreign currency;

(e) regulator trade barriers;

(f) taxes imposed on international trade;

(g) private sector credit;

(h) hiring and firing regulations;

(i) price controls;

(j) starting a business and licensing restrictions;

(k) bribes and extra payments.

For each of the 141 economies covered by the index, a detailed breakdown is conducted. More than 40 separate numerical ratings are applied, which allows one to: (a) undertake a diagnostic of where a specific economy is faring less well; (b) make cross-economy comparisons; and (c) monitor a single economy's performance over time, across any of the 42 elements that are measured by the index. For example, Viet Nam ranks relatively high in terms of "freedom to trade internationally" and "regulation of credit, labour and business". However, it scores worst on the "access to sound money" component, which then drags down its aggregate ranking.

Thirdly, there is the Global Competitiveness Index. Like the previous two indices, this index does not focus on SMEs per se, but measures a range of issues that are highly pertinent to SME development, namely "the set of institutions, policies and factors that determine the level of productivity of a country" (Sala-i-Martin and others 2008, 3). Briefly, as discussed in *The Global Competitiveness Report 2008-2009* (Sala-i-Martin and others 2008), the World Competitiveness Index tracks 12 pillars of economic competitiveness, which are grouped into three elements. The first element contains four pillars that are essential for a factor-driven economy, namely: institutions, infrastructure, macroeconomic stability, and health and primary education. The second element contains six pillars that are essential for an efficiency-driven economy, namely: higher education and training, goods market efficiency, labour market efficiency, financial market sophistication, technological readiness, and market size. And the final element contains two pillars that are essential for an innovation-driven economy, comprising: business sophistication and innovation.

Table 5 shows the rankings for the Asia-Pacific economies included in the Global Competitiveness Index.

Table 5. Global Competitiveness Index: rankings for Asia-Pacific economies

Economy	Rank	Economy	Rank
Singapore	5	Kazakhstan	66
Japan	9	Viet Nam	70
Hong Kong, China	11	Philippines	71
Republic of Korea	13	Sri Lanka	77
Taiwan Province of China	17	Mongolia	100
Australia	18	Pakistan	101
Malaysia	21	Cambodia	109
New Zealand	24	Bangladesh	111
China	30	Tajikistan	116
Thailand	34	Kyrgyzstan	122
Brunei	39	Nepal	126
India	50	Timor-Leste	129
Indonesia	55		

Source: Xavier Sala-i-Martin, Jennifer Blanke, Margareta Drzeniek Hanouz, Thierry Geiger, Irene Mia and Fiona Paua, "The Global Competitive Index: Prioritizing the Economic Policy Agenda", in Michael E. Porter and Klaus Schwab, eds., *Global Competitiveness Report 2008-2009* (World Economic Forum, Geneva, 2008), table 3, p. 10.

An interesting, and relatively recent, development has been the creation of subnational indices, such as the Provincial Competitiveness Index in Viet Nam, and an off-shoot of this in Cambodia.[5] Such an approach recognizes that most SMEs have relatively limited relationships with national agencies and the like, and that they interface rather with municipal or provincial bodies, and conduct their activities largely or entirely within that sphere. Thus, the Provincial Competitiveness Index seeks to measure and rank the business conditions—allowing for "initial conditions", such as natural-resource endowments—for private sector development in each of the 64 provinces of Viet Nam. Such an exercise is highly pertinent to SME development, as it focuses on 10 principal factors that impact SMEs, comprising: (a) costs of market entry; (b) access to land and security of tenure; (c) issues relating to the transparency of regulations and their enactment by provincial bodies; (d) the time required to be compliant with regulations; (e) informal charges imposed; (f) bias towards State-owned enterprises; (g) the proactivity of provincial authorities to assist firms; (h) the provision of private sector development services; (i) the availability of training for employees; and (j) the quality of legal institutions.

In the case of Cambodia, a provincial business environment scorecard was developed, spanning the country's 10 most economically active provinces. Like the Provincial Competitiveness Index in Viet Nam, 10 sub-indices were developed for measuring the enabling environment in these provinces, but tailored to meet the slightly different conditions in Cambodia, including, among others: tax administration, crime prevention and dispute resolution.

1.2. Market entries, survival, prosperity and exits

> *Nobody talks about entrepreneurship as survival, but that's exactly what it is and what nurtures creative thinking.*
>
> *Anita Roddick, founder of The Body Shop*[6]

Let us now turn to SME development, and policymaking in support of that development process, as it pertains to four stages in the SME life cycle: market entry, survival, possible prosperity, and ultimate exit. Some SMEs may encounter just one or two of these stages (such as entry and exit), while other SMEs may experience all four stages. Policymakers typically pay the most attention to market entry, and relatively less effort is expended on the latter stages, for understandable reasons. But this asymmetry in the focus of most SME development can be misguided in some cases. For example, too much emphasis on removing market-entry obstacles alone can, over time, result in diminishing returns for policymakers and development partners. Rather, there needs to be a balanced portfolio of interventions that can assist SMEs in overcoming obstacles throughout their development trajectory.

There are varying perspectives on the relationship and delineation between SMEs

[5] The Provincial Competitiveness Index in Viet Nam was developed by The Asia Foundation as part of the Viet Nam Competitiveness Initiative funded by the United States Agency for International Development (USAID). The Cambodia variant was also developed by The Asia Foundation, with support from the International Finance Corporation-Mekong Project Development Facility and the Australian Agency for International Development (AusAID).

[6] www.anitaroddick.com.

and entrepreneurs, and thus between SME development and entrepreneurial development initiatives. Most start-up ventures tend to be small, and therefore much of the policy-related literature pertaining to entrepreneurship is also highly relevant to SMEs. That said, SME development and entrepreneurship support are not wholly synonymous. An SME can be entrepreneurial in its endeavours, but this is not universal. For example, an SME that has been established out of necessity or that is a long-established family business (common in countries where the legal protection of property and investor rights is weak) differs significantly from an individual or individuals pursuing a very specific perceived business opportunity.[7]

For entrepreneurialism to be vibrant in an economy, a willingness by individuals to take (calculated) business risks must also be present. If the social stigma associated with business failure is perceived to be too great, or the practical repercussions of business closure are too onerous (for example, if the difficulty or cost of closing a company is too great), then entrepreneurialism will not flourish easily. In addition, the right kinds of economic incentives need to be in place to prompt potential entrepreneurs to take a leap into the unknown. If the prospect of relatively substantial financial gain is a dim one, then the motivation to venture will no doubt be constrained. That in turn necessitates that the development of new products and services can be monetized (translated into a source of income) in some manner by new business ventures. But in developing countries, where incomes are often low, and thus consumer spending power is limited, and where intellectual property right protection is often inadequate, this can be a real problem.

The Global Entrepreneurship Monitor sees entrepreneurial endeavour evolving in different ways, depending on the economic stage of the host economy. First, for a less developed, factor-driven economy, the shift from agricultural sector dominance to greater industrial activity creates a dynamic described as follows in the *2008 Executive Report* of the Global Entrepreneurship Monitor:

> As extractive industry starts to develop, this triggers economic growth, prompting surplus population from agriculture to migrate toward extractive and emergent scale-intensive sectors, which are often located in specific regions. The resulting oversupply of labour feeds subsistence entrepreneurship in regional agglomerations, as surplus workers seek to create self-employment opportunities in order to make a living. (Bosma and others 2008, 8)

Secondly, for a developing, efficiency-driven economy, the development of the industrial sector creates new venture opportunities that can be harnessed by entrepreneurs, thus:

> As the industrial sector develops further, institutions start to emerge to support further industrialization and the build-up of scale in the pursuit of higher productivity through economies of scale. Typically, national economic policies in scale-intensive economies shape their emerging economic and financial institutions to favor large national businesses. As increasing economic productivity contributes to financial capital formation, niches may open in industrial supply chains that service these

[7] Entrepreneurial initiatives are sometimes said to go through at least four stages: (a) conception or identification; (b) gestation or evaluation; (c) infancy or explosion; and (d) adolescence or exploitation.

national incumbents. This, combined with the opening up of independent supply of financial capital from the emerging banking sector, would expand opportunities for the development of small-scale and medium-sized manufacturing sectors. (Bosma and others 2008, 8)

And finally, in an industrialized, innovation-driven economy, a third pro-entrepreneur dynamic usually becomes apparent, thus:

> The industrial sector evolves and experiences improvements in variety and sophistication. Such a development would be typically associated with increasing research and development and knowledge intensity, as knowledge-generating institutions in the economy gain momentum. This development opens the way for the development of innovative, opportunity-seeking entrepreneurial activity that is not afraid to challenge established incumbents in the economy. Often, small and innovative entrepreneurial firms enjoy an innovation productivity advantage over large incumbents, enabling them to operate as 'agents of creative destruction.' To the extent that the economic and financial institutions created during the scale-intensive phase of the economy are able to accommodate and support opportunity-seeking entrepreneurial activity, innovative entrepreneurial firms may emerge as significant drivers of economic growth and wealth creation. (Bosma and others 2008, 8)

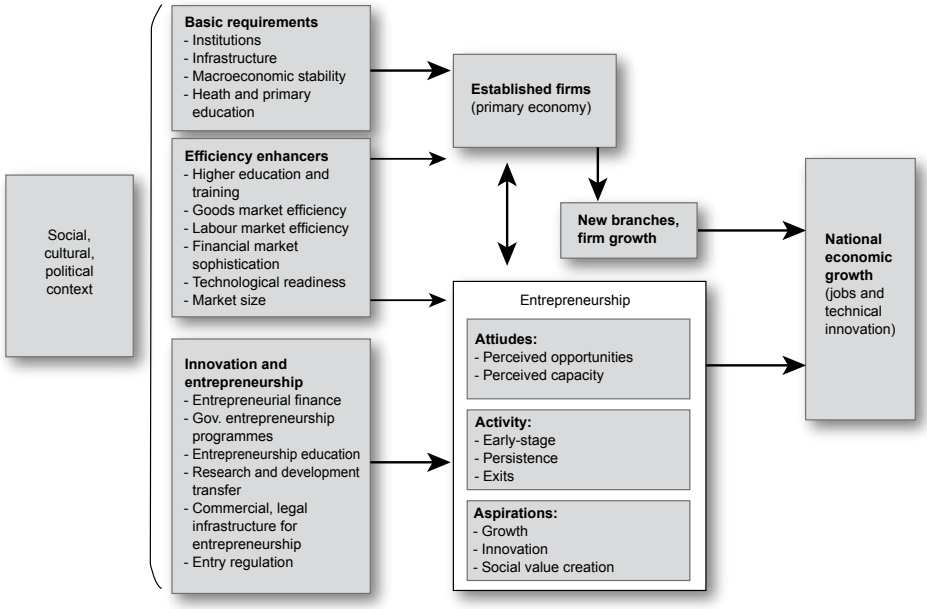
Not surprisingly perhaps, views differ widely (Wennekers and Thurik 1999; Davidsson 2004; Godin and others 2008) on what are the key elements necessary to promote entrepreneurial endeavour in an economy. But clearly, the kind of "hothouse environment" necessary to seed, pollinate, nurture and harvest entrepreneurial initiatives is not easy to achieve, particularly in countries where government resources are limited. Even the advanced and affluent city-State of Singapore has had only mixed success in its relatively recent forays into developing a more vibrant and entrepreneurial business community, despite being able to apply quite considerable financial resources to this effort (see, for example, the website of SPRING Singapore at www.spring.gov.sg). Government funding initiatives in support of SME development (both debt and equity) in Singapore include the SPRING Startup Enterprise Development Scheme, Business Angels Scheme, Growth Financing Programme, Micro-Loan Programme, Local Enterprise Finance Scheme, Loan Insurance Scheme, Export Coverage Scheme (trade credit insurance), and the Internationalisation Finance Scheme.

Furthermore, Singapore is part of a relatively elite group of economies in the Asia-Pacific region with a strong industry of private sector fund management that can also pursue the venture capital/private equity support of the SME sector. One recent example is the S$30 million Sirius SME Growth Partners I fund, focused exclusively on SMEs located in the city-State. Launched in May 2008, with an initial closing of S$15 million, it aims to invest S$2 million-3 million in about 10-12 "growth and expansion-stage SMEs in various industries, who can be leaders in their respective fields" (see www.sirius.com.sg/Sirius_growth_fund.html). Exit is likely to be through trade sales or a listing on Singapore's secondary market for smaller enterprises.

This underlines the extent to which multiple economic, financial, industrial, social, cultural and other nuances are sometimes necessary, in addition to the basic regulatory structures and economic platform. The Global Entrepreneurship Monitor cites a cocktail

of: (a) entrepreneurial attitudes; (b) entrepreneurial activity; and (c) entrepreneurial aspiration, which it then seeks to quantify through a series of analytical measures.[8] The consortium goes on to propose what it calls the Entrepreneurial Framework Conditions, which tend to differ, depending on the stage of the underlying economy, as discussed earlier (see figure 1).

Figure 1. The Global Entrepreneurship Monitor model of entrepreneurship and economic development



Source: Niels Bosma, Zoltan J. Acs, Erkko Autio, Alicia Coduras and Jonathan Levie, *Global Entrepreneurship Monitor 2008 Executive Report* (Global Entrepreneurship Research Consortium, 2009) available at www.gemconsortium.org/download/1240814294671/GEM_Global_08.pdf.

It needs to be underlined, however, that SME development and entrepreneurial development are not synonymous. Many (and probably most) SMEs are not entrepreneurial in nature. Rather, entrepreneurial business ventures often tend to be a subset of the SME sector, and are perhaps the most attractive to policymakers, given the prospect or potential they have for contributing most to economic growth and development.

1.2.1. Entry: what does it take to set up an SME?

The first critical stage in the development of an SME is that of market entry, or start-up. This entails all the steps and procedures to get a business up and running in compliance with the laws and regulations of the host country. There are typically two important factors in this regard: (a) the time is takes to start up a business; and (b) the cost

[8] Sadly, in the latest iteration of the Global Economic Monitor study, only two Asia-Pacific economies (Republic of Korea and Japan) were among the 43 countries taking part.

of doing so. Unreasonable waiting times and/or prohibitive costs can be major barriers for many potential new businesses, and can translate into a potentially major opportunity cost for the economy, in terms of, among other things, jobs foregone and income not generated. Within the Asia-Pacific region, Azerbaijan is recognized as one developing country that has made considerable improvements in its regulatory framework relating to start-up.[9]

But these are certainly not the only potential inhibitors to greater SME start-up rates. For example, if an entrepreneur is unable to gain access to the capital needed to finance the planned business venture, he or she may opt not to proceed. Another inhibitor can actually be found at the opposite end of the SME life cycle: closure. If the regulations pertaining to shutting down a business or bankruptcy are too onerous, then an entrepreneur may be unwilling to take the risk of establishing an SME, given the risks attendant with any new business, and the possibility of failure resulting in a gratuitously arduous process of legal closure.

While the obstacle posed by high costs of market entry can be easily understood, the obstacle posed by a time-consuming process is perhaps a little less apparent. For some business ventures, the timing of market entry can be an important determinant of success. If a business opportunity opens, but subsequently closes (for whatever reason) before all the regulatory hurdles associated with start-up are completed, then it is likely that fewer SMEs will be established. Returning to the Doing Business rankings again, table 6 shows the figures for Asia-Pacific economies covered by the survey, in terms of the ease of starting a business. This indicator is aimed at measuring the bureaucratic and regulatory hurdles that an entrepreneur must typically navigate through in order to incorporate a new firm that employs up to 50 staff and has start-up capital that is 10 times the per capita gross national income of the relevant country. There are some striking contrasts to be discerned, most noticeably in the number of days required to commence a business, which ranges from 1 to 116 days.

Table 6. *Doing Business 2009:* starting a business in the Asia-Pacific region

Economy	Number of procedures required	Number of days required	Cost (percentage per capita GNI)
Average for East Asia and the Pacific	8.6	44.2	32.3
Average for South Asia	7.4	32.5	31.9
Afghanistan	4	9	59.5
Australia	2	2	0.8
Azerbaijan	6	16	3.2
Bangladesh	7	73	25.7
Bhutan	8	46	8.5

[9] See the starting-a-business case study on Azerbaijan produced by the Doing Business project: Svetlana Bagaudinova, Dahlia Khalifa and Givi Petriashvili, “Azerbaijan business registration agencies cooperate on a new one-stop-shop”, in Bruce Ross-Larson, ed., *Celebrating Reform* (Washington D.C., International Finance Corporation, World Bank and USAID, 2008).

Brunei	18	116	9.2
Cambodia	9	85	151.7
China	14	40	8.4
Fiji	8	46	25.2
Hong Kong, China	5	11	2.0
India	13	30	70.1
Indonesia	11	76	77.9
Japan	8	23	7.5
Kazakhstan	8	21	5.2
Kiribati	6	21	64.6
Kyrgyzstan	4	15	7.4
Lao People's Democratic Republic	8	103	14.1
Malaysia	9	13	14.7
Maldives	5	9	11.5
Marshall Islands	5	17	17.3
Micronesia (Federated States of)	7	16	137.5
Mongolia	7	13	4.0
Nepal	7	31	60.2
New Zealand	1	1	0.4
Pakistan	11	24	12.6
Palau	8	28	4.6
Papua New Guinea	8	56	23.6
Philippines	15	52	29.8
Republic of Korea	10	17	16.9
Samoa	9	35	39.8
Singapore	4	4	0.7
Solomon Islands	7	57	53.6
Sri Lanka	4	38	7.1
Taiwan Province of China	8	42	4.1
Tajikistan	13	49	27.6
Thailand	8	33	4.9
Timor-Leste	10	83	6.6
Uzbekistan	7	15	10.3
Vanuatu	8	39	54.8
Viet Nam	11	50	16.8

Source: World Bank, *Doing Business 2009* (Washington D.C., 2009).
Abbreviation: GNI, gross national income.

It stands to reason that if it takes more than 100 working days to incorporate a new, small company in a country, then fewer entrepreneurs will take the plunge and embark on a business venture. A long delay in start-up also serves as a leading indicator that other, subsequent regulatory hassles associated with actually operating an SME (such as the granting of specific licences, tax appraisals or various site inspections) will also be onerous or problematic, thereby deterring entrepreneurs further.

Some observers have argued that the start-up phase for an SME usually lasts about 3.5 years (or 42 months). If an SME passes that landmark date, then it has graduated beyond the critical period when most young companies tend to fail, and therefore can be regarded as a potentially sustainable business. Interestingly, the Global Entrepreneurship Monitor project has discerned a U-shape relationship between a country's SME start-ups and its level of economic development (as measured by per capita income) (Bosma 2009). In relatively poor countries, the pace of SME start-ups can be quite impressive, but this pace then declines as the economy develops and more formal (salaried) employment opportunities evolve. Then, as the economy develops further, the pace of start-ups begins to increase again, as the domestic demand for services and goods rise, particularly for highly individualized items where economies of scale are of less relevance.

1.2.2. Survival: what does it take to advance beyond start-up?

> *.The transformation from a low-income, traditional economy to a modern economy . . . involves significant changes to production methods, a process of change where entrepreneurs provide essential roles: first, in creating new firms [i.e. SMEs] outside of the household, which offer new products; and second, in growing firms by making use of scale economies. Such larger firms tend to specialize, and the clustering of specialized firms can give rise to localization economies, further encouraging innovation and specialization.*
>
> *Wim Naudé (2008, 22).*

Once an SME has successfully entered the market and commenced operations, a number of other factors will be critical in its subsequent performance, determining whether it can sustain its business model beyond the short term, and dictating whether it will be simply a survivor, or go on to prosper as a competitive entity. Those factors entail an interplay between the SME itself and its wider enabling environment. Key inputs include (but are not limited to) access to: (a) accurate and timely market information, and an ability to analyse that information in a meaningful way; (b) a range of appropriate financial resources; (c) high quality human capital; (d) technology; and (e) suitable premises. The more conducive the enabling environment; the more likely it is that SMEs will thrive.

In most cases, government agencies should not be in the business of providing these inputs directly to individual SMEs, as experience shows their ability to do so is mixed, and as such they can inadvertently undermine the development of more sustainable input providers. But policymakers do need to ensure that they are providing the kind of benign enabling environment that allows these inputs to be available, only stepping in directly when there is a clear inability of the private sector to provide such inputs, and for as briefly as necessary.

A good example is that of financing. In general, government agencies make bad bankers and private equity investors, as they lack the necessary expertise. But governments do need to ensure that SMEs have recourse to a spectrum of finance providers that offer a suitably diverse range of financial products and services. Bank loans tend to dominate this sphere, but high debt levels can sink an SME, and SMEs will be vulnerable if they rely too much on this kind of funding. If banks reduce their lending, or increase interest rates, then SMEs that rely too much on loans will suffer. It is therefore important that other pro-SME forms of financing are available, such as financial leasing, factoring, private equity and angel investing.

There is much that governments can do in this sphere, including: (a) ensuring that the regulatory framework pertaining to financing is supportive of SME-oriented funding, or at least does not constrain it; (b) catalyzing the creation and use of credit risk and scoring services that can radically reduce the perceived costs of lending to SMEs;[10] and (c) ensuring that agencies such as secured transaction registries are available, to lessen the risks associated with SME lending.

Indeed, improving access to finance is perhaps one of the most common interventions by policymakers and development partners in their efforts to support SME development. (For a profile of some of these, see Freeman 2005.) This is often because many respondents in diagnostic studies of SME development constraints perennially cite the common complaint that access to finance is inadequate. However, such responses need to be treated with some caution, as these comments can "often mask technical and managerial inadequacies" within SMEs (Gries and Naudé 2008a, 4). Rather, financing constraints play a more critical role later on, when operational SMEs are seeking to expand and develop, but lack access to sufficient long-term funding sources in particular.

Beyond debt financing, most commonly in the form of bank loans or a revolving overdraft facility, SMEs often struggle to identify alternative sources of funding, and particularly long-term funding. Ideally, private equity/venture capital is seen as an attractive proposition, as it often comes with value-added post-investment technical assistance and business strategy guidance attached to it. (Rarely do banks provide much in the way of technical assistance attached to a loan.) But most SMEs are typically too small to be eligible for this kind of equity financing (let alone an initial public offering); the transaction costs of conducting such an investment are quite high, which in turn makes investments of less than $5 million often hard to justify or engineer. Only highly prospective SMEs, with perceived potential for steep growth, are likely to make the grade. One hybrid form of financing that has been developed to try and fill this "equity finance-cum-technical assistance" gap in SME funding has been that of business angels and business angel networks. Here, high net-worth individuals, often retired after a successful career in a particular industry, take a personal equity stake in an SME and seek to mentor that business. This can be an attractive option for long-term funding support of SMEs. For more short-term funding needs, services like leasing and factoring also have very clear attractions as alternatives to "plain vanilla" debt financing.

[10] SME-oriented lending is typically seen as having high transaction costs, relative to the amounts lent. This deters banks from lending to SMEs, and conversely lending activities are focused on bigger corporate clients. One way of lessening the transaction costs of things like credit appraisal and customer due diligence is to have credit scoring bureaus.

The 2008 credit crunch: some initial considerations

The recent dramatic events in global banking and financial markets throughout 2007 and 2008 will doubtless add to the financial constraints of SMEs in many Asia-Pacific economies in 2009-2010, even if the true severity of the impact is hard to gauge. Bank credit is the most common type of formal finance relied on by SMEs, and there is little doubt that bank credit—of all kinds—is almost certainly going to be scarcer in the near term.

There is also likely to be a flight away from risk by financiers of all kinds, with regard to assets of all kinds, and SMEs will not be immune. While there is some debate as to whether SME-related financing is more risky per se, or just entails a different kind of risk, we can expect bankers to be more discerning in their lending behaviour towards smaller firms. As credit becomes rationed, those SMEs most in need of funding are likely to be hardest hit, as bankers gravitate towards firms with an established track record of being credit worthy.

Of course, some SMEs are actually financed from personal loans (and even mortgages) taken out by their owners. But these forms of credit too will probably be less freely available in the near term. The anticipated global recession will also likely make it more difficult for individuals to provide loans to relatives, colleagues and friends, further tightening credit for the SMEs that rely on such informal financing.

The relatively small proportion of SMEs able to attract equity capital will also find the going harder. Private equity and venture capital companies will themselves find it harder to raise funding for investment, and will not be able to leverage their acquisitions as much. With less equity capital available, deals will be scarcer, and the internal rates of return expectations of investors will be higher.

Although not specific to SME finance per se, the Milken Institute produces an annual survey of countries and their access to capital for business, entitled the Capital Access Index. The index is comprised of 56 different measures, grouped under seven categories: (a) macroeconomic environment; (b) institutional environment; (c) financial and banking institutions; (d) equity market development; (e) bond market development; (f) alternative sources of capital; and (g) international funding.[11] Not all of these groupings are wholly appropriate to SME financing, but a, b, c and f are highly relevant. At present, 122 economies are included in the Capital Access Index, and those located in the Asia-Pacific region are shown in table 7, along with their aggregate score and ranking for 2007.

[11] For details of the methodology used, see Appendix A of the report, which can be downloaded at: www.milkeninstitute.org/publications/publications.taf.

Table 7. Capital Access Index 2007: Asia-Pacific economies compared

Economy	Capital Access Index score (2007)	Country rank in 2007 (out of 122 countries)
Hong Kong, China	8.27	1
Singapore	7.88	4
Australia	7.61	8
Malaysia	7.14	13
Japan	7.07	15
New Zealand	7.00	18
Republic of Korea	6.87	19
Taiwan Province of China	6.57	25
Thailand	6.36	26
India	5.50	41
China	5.26	45
Philippines	4.50	62
Indonesia	4.40	64
Sri Lanka	4.11	70
Pakistan	4.06	72
Viet Nam	3.98	74
Papua New Guinea	3.77	79
Mongolia	3.36	90
Bangladesh	3.24	92
Cambodia	3.00	98
Lao People's Democratic Republic	2.11	119

Source: James R. Barth, Tong Li, Wenling Lu, Triphon Phumiwasana and Glenn Yago, *Capital Access Index 2007: Best Markets for Business Access to Capital,* (Santa Monica, Milken Institute, 2008).

But access to finance is by no means the only determinant of a conducive business enabling environment. Good governance and minimal red tape can also be an important determinant as the corollary, that is, burdensome bureaucracy and corruption, can be a major disincentive for entrepreneurial endeavour. This is not to suggest that an economy should seek to completely do away with necessary regulation and oversight, as this is still required to ensure that SMEs and other business ventures do not pursue activities that are detrimental to society, the environment, the wider economy, and so on. Ex ante approvals, as well as inspections and other forms of ex post regulatory oversight, are inevitable, at least in some fields of business that SMEs will pursue. But where such regulations and their implementation are gratuitous in nature and entail an unnecessary compliance cost or opportunity cost for SMEs, they will serve as an inhibitor of business.

This can sometimes stem from a desire by State agency officials to extract additional "rents" from businesses, including SMEs. Transparency International undertakes an annual Corruption Perceptions Index exercise that scores and ranks economies according to the perceived level of corruption. Regardless of whether one agrees or disagrees with the methodology used to generate such indices, the perceived level of corruption will be a factor in any decision made to pursue a business, even among start-up, domestic SMEs, as it raises the spectre of heightened costs and business risk. Table 8 includes those Asia-Pacific economies included in the 2008 iteration of the index.

Table 8. Corruption Perceptions Index: the rankings of Asia-Pacific economies compared

Economy	2008 ranking	Economy	2008 ranking
New Zealand	1	Maldives	115
Singapore	4	Nepal	121
Australia	9	Viet Nam	121
Hong Kong, China	12	Indonesia	126
Japan	18	Philippines	141
Taiwan Province of China	39	Kazakhstan	145
Republic of Korea	40	Timor-Leste	145
Bhutan	45	Bangladesh	147
Malaysia	47	Lao People's Democratic Republic	151
Samoa	62	Papua New Guinea	151
China	72	Tajikistan	151
Thailand	80	Azerbaijan	158
India	85	Cambodia	166
Sri Lanka	92	Kyrgyzstan	166
Kiribati	96	Turkmenistan	166
Mongolia	102	Uzbekistan	166
Solomon Islands	109	Myanmar	178
Vanuatu	109		

Source: Transparency International, *Transparency International 2008 Corruption Perceptions Index* (Berlin, Ernst & Young Global Limited, 2008), available at www.transparency.org/policy_research/surveys_indices/cpi/2008.

One area where bureaucracy can often be particularly burdensome, notably for manufacturing-related SMEs, is in the area of land acquisition/availability and construction. Firms that are unable to find and develop adequate premises may not be able to commence operations, or may remain constrained at a sub-optimal size that prevents them from developing economies of scale and renders them uncompetitive with their peers. Hence, there is a need for policymakers to ensure that adequate land

is available for SMEs to establish viable operations, and that access to this land—and registering legitimate ownership rights—is not hindered by excessive red tape and/or corrupt practices. The same imperative pertains to the provision of construction permits and all the other approvals that an SME might require before erecting and inhabiting new premises. Industrial zones and incubators (addressed in more detail below), where some of the normal procedures can be circumvented, may provide part of the answer. However, it is hardly conducive to SME development, particularly in the broad field of manufacturing, when, as in some economies, it takes up to a year to complete the 25 or more regulatory steps necessary to commission a new building.

A similar issue pertains to the taxation of SMEs. A regulatory system that makes tax compliance unduly burdensome can create a major distraction and opportunity cost for the typically small number of managers and/or owners of an SME. Further, a tax regime that is overly complex or opaque in its administration and enforcement serves to make the risks of pursuing business far greater. Any sustainable business model requires some calculation of (after tax) profitability and internal rate of return, but that becomes hard to achieve if the tax liability of an SME is hard to forecast or unknown. Complex or inequitable tax regimes can also have a distortionary effect on the development of SMEs, as they are tempted to morph into forms that seem to offer a lower tax burden. But if the tax regime itself changes, as is often the case, then an SME can be rendered unviable because it was reliant on some prior tax ruling, and now finds itself with an unsustainable business model.

Simplicity, consistency and predictability tend to be the best watchwords for pro-business (and pro-SME) tax regimes and their enforcement. Recognizing that the tax regime, bureaucracy, licensing and other regulatory compliance elements for SMEs are often less than ideal, there is a common tendency for policymakers to offer incentives and other kinds of inducements, intended to offset these additional compliance costs and risks, rather like a palliative. On their part, SMEs that are surveyed will rarely say that they dislike tax or other incentive measures offered by the government, as they do offer some pragmatic value. But where the doling out of incentives makes the regulatory regime more complex, and therefore often harder to implement fairly and transparently, the consequences can actually backfire. SMEs and potential entrepreneurs see a regulatory regime that is even more laden with risk and uncertainty, and opt not to pursue business ventures for fear of encountering obstacles that are not readily apparent or that are hard to predict in terms of their impact.

A slightly more controversial issue is that relating to employment regulations, and the relative ease with which SMEs can hire, oversee and fire staff while remaining legally compliant. For example, there may be limits in the local labour code or law on the number of hours that employees may work per day or week. There may be a minimum number of weeks' salary that an employee is entitled to when laid off, or other regulatory requirements that must be fulfilled before an SME can make an employee redundant. As with regulations pertaining to the environment, there is a need to balance the interests of SMEs with that of the wider economy and society. If the regulatory regime is too onerous, then a country is in danger of regulating its business community, including SMEs, out of business. Yet a too passive regulatory regime towards business can see damage inflicted that is not conducive to sustainable development.

For SMEs in less developed countries, and small economies in particular (such as the island economies of the Pacific, or the landlocked economies of Bhutan, the Lao People's Democratic Republic and Nepal), another key determinant of long-term success—for SME development and sustained economic growth in general—is the ability to export products or services, which increasingly involve parts and components. Indeed, most firms will probably, sooner or later, aspire to serve international customers. And even SMEs that are wholly oriented towards a domestic market may need to import some items. In this context, the ability of firms to buy and sell relatively easily across national borders is another essential prerequisite for SME development, particularly in the context of the globalization of production, as will be discussed in section 2.

In general, SMEs typically cannot thrive in splendid isolation. Rather, they need to be part of a wider and vibrant corporate community, both domestically and internationally, into which they can be integrated and burgeon. It is the free flow of information, finance, human capital, skills, technology and other key inputs, between SMEs and other members of the wider economy and corporate community, that allows individual SMEs to find their competitive niches, and to be successful. This "traffic" of inputs can be facilitated and promoted through various platforms and vehicles, particularly in developing countries. One such vehicle is foreign direct investment, whereby more technically advanced overseas firms can assist local SMEs through backward linkages of various kinds. (This is explored in greater detail in the fourth section of this study.)

Another platform is business associations, which should allow members to pool and share information. Business associations may be centred on a particular location (such as a city or province), a particular industry or product, or a slightly more abstract shared goal or interest of some kind. Business incubators and clusters are another platform, often structured as public-private (or purely private) partnerships. The aim is to allow multiple SMEs to benefit from economies, synergies and other benefits derived from being located together. Indeed, there is a considerable research literature surrounding the issue of incubators and clusters for SME development, based on initiatives and experiences undertaken across the globe. As the term suggests, incubators are designed to help youthful enterprises make it through the first, critical stages of business development, as they seek to graduate to the level of a sustainable business.[12]

It should be borne in mind, however, that not all SMEs aspire to become larger enterprises. Many owners of SMEs wish to keep their business small in scale, for whatever reason. This may be because it is a family business, and the owner(s) wish to keep it that way. It may be because the SME supports a lifestyle that is deemed comfortable and adequate, so there is no need to aspire to anything more grand. Or it could be because an SME-owner worries about the so-called "tall poppy syndrome", whereby larger firms attract unwelcome attention of various kinds, so feels it is better to remain small. Or this may be because the business model itself is not easily expandable (sometimes referred to as scalable), for whatever reason, and will remain a small, niche player.

[12] However, not all SMEs are attracted to clusters or incubators, despite the apparent economies and value-added inputs that may be on offer. One reason may be that, in being located so close to other firms of a similar kind, SME owners worry that key employees will be more easily tempted away by rival companies, or that commercially sensitive information is more likely to leak out in the canteen or other shared space.

1.2.3. Exit: what can we learn from the demise of SMEs ?

> *". . . most firms die young".*
>
> *R. Cressy (2006)*

Turning now to SME exits, there are perhaps two scenarios we need to consider. The first is that an SME develops into a large enterprise, and therefore graduates beyond the SME sector. For all concerned, this is perhaps the most welcome outcome for an SME in most cases. The second is the actual demise and closure of an SME, for whatever reason. (As Headd (2003) notes, not all SME closures stem from business failure; some are the consequence of an orderly exit by the owner(s).)

The latter is undoubtedly a much less welcome outcome than the former, in most cases, but it should not be dismissed as a policy irrelevance. It is inevitable that not all SMEs will be successful ad infinitum. Some will have an early demise, while others may close after quite a considerable time. In general, at least half of all new companies close within two years of commencing operations. One study in the United States found that 40 per cent of manufacturing firms were defunct within five years of beginning operations. And there is clearly little utility in allocating resources that seek to artificially prolong the life of a terminally ill SME. Rather, the important issue for policymakers to ensure is that their passing does not become a constraint on new SMEs emerging, and hopefully some (hard) lessons learned are disseminated into the collective awareness of the local business community. A form of knowledge management process, if you will.

While countries are often quite zealous at recording and reporting new company start-ups, they tend to be much less focused on recording company closures. Thus, in some countries, the "births" of SMEs are diligently counted, but the "deaths" of most failed SMEs go completely unrecorded. This is the case in Viet Nam. In fact, few companies in Viet Nam actually go through the regulatory process of formally closing. Instead, many go into a state of suspended animation, which has the attraction of being able to revive the company at a later stage, should conditions change for the better. Also, the fact that it can take five years to formally close a bankrupt company serves as a deterrent against officially closing a company. But this then makes it difficult for business service providers, including banks and financiers, to have a clear picture of the SME community. This in turn adds to the risks for service providers of various kinds, which are passed on to SMEs as higher fees. For example, banks will charge a higher rate of interest on loans to SMEs, to mitigate the higher risks associated with such opacity. Equity financiers will expect a higher rate of return on their investment to mitigate the same higher perceived risk. Perhaps the most comprehensive and accurate picture of the SME community in a developing country is held by the tax authority, but this information is rarely in the public domain, or even shared among pertinent government agencies.

Returning once again to the Doing Business survey, problems encountered in undergoing company bankruptcy are measured and compared, in terms of: (a) the average time to complete the bankruptcy process; (b) the average cost of this process; and (c) the recovery rate (how many cents on the dollar claimants can expect to recover from an insolvent company). The results for economies in the Asia-Pacific region are shown in table 9.

Table 9. *Doing Business 2009:* closing a business in Asia and the Pacific

Economy	Time required (in years)	Cost (percentage of estate)	Recovery rate (cents on the dollar)
Average for East Asia and the Pacific	2.7	23.2	28.4
Average for South Asia	5.0	6.5	19.9
Afghanistan	-	-	0.0
Australia	1.0	8.0	78.8
Azerbaijan	2.7	8.0	30.1
Bangladesh	4.0	8.0	23.2
Bhutan	-	-	0.0
Brunei	2.5	4.0	47.2
Cambodia	-	-	0.0
China	1.7	22.0	35.3
Fiji	1.8	38.0	20.1
Hong Kong, China	1.1	9.0	79.8
India	10.0	9.0	10.4
Indonesia	5.5	18	13.7
Japan	0.6	4.0	92.5
Kazakhstan	3.3	18.0	25.3
Kiribati	-	-	0.0
Kyrgyzstan	4.0	15	14.2
Lao People's Democratic Republic	-	-	0.0
Malaysia	2.3	15.0	38.6
Maldives	6.7	4.0	18.2
Marshall Islands	2.0	38.0	17.9
Micronesia (Federated States of)	5.3	38	3.5
Mongolia	4.0	8.0	22.0
Nepal	5.0	9.0	24.5
New Zealand	1.3	4.0	76.2
Pakistan	2.8	4.0	39.2
Palau	1.0	23.0	38.2
Papua New Guinea	3.0	23.0	24.7
Philippines	5.7	38.0	4.4
Republic of Korea	1.5	4.0	80.5
Samoa	2.5	38.0	14.3

Singapore	0.8	1.0	91.3
Solomon Islands	1.0	38.0	23.6
Sri Lanka	1.7	5.0	43.4
Taiwan Province of China	1.9	4.0	80.9
Tajikistan	3.0	9.0	25.4
Thailand	2.7	36.0	42.4
Timor-Leste	-	-	0.0
Uzbekistan	4.0	10.0	18.7
Vanuatu	2.6	38	41.2
Viet Nam	5.0	15.0	18.0

Source: World Bank, *Doing Business 2009* (Washington D.C., World Bank, 2009).

Clearly, the relative ease with which a bankrupt SME can be wound up, and the amount that claimants (creditors, employees and tax agencies) can recover, have an impact on the perceived risk of SMEs. This in turn will influence the extent to which subsequent SMEs can access key inputs, most notably finance. In Singapore, for example, where a bankrupt SME can be wound up in less than a year, and claimants have a recovery rate of over 90 per cent on average, there is going to be a far greater likelihood that banks will lend to SMEs, compared with Cambodia or the Lao People's Democratic Republic, for example, where the bankruptcy process is virtually non-existent. In the latter countries, banks will be much more conservative in lending to SMEs, knowing that they will have little or no chance of recovering the loan amount should the borrower become bankrupt. Little wonder, therefore, that Singapore ranks far higher than Cambodia or the Lao People's Democratic Republic, for example, in the Milken Institute's Capital Access Index.

There is a relatively strong correlation between the ease of access a SME has to capital and the degree to which: (a) investors are protected; and (b) contracts can be enforced in a particular country. One often tends to think of investor protection within the wider context of corporate governance, and for larger, stock-market-listed companies in particular, where there is a need to ensure that the management of the company is working in the interests of what can be a very widespread shareholder base, including many minority shareholders. But it also applies to many SMEs also, even if their shareholder base is quite small indeed. The Doing Business survey assesses investor protection in terms of: (a) the transparency of transactions; (b) liability for self-dealing; and (c) the ability of shareholders to sue directors and officers for misconduct. This may not seem particularly relevant to most SMEs, but the manner with which a company conducts its activities and governs its internal practices, and the extent to which stakeholders have some legal recourse in cases of improper behaviour, are the sorts of issues that banks will focus on when appraising SME loan applicants.

The same broad dynamic pertains to contract enforcement, as a bank will be less willing and able to provide capital to an SME if it knows that a loan default will be difficult (costly, time-consuming or involving an uncertain outcome) to pursue by conventional legal means, notably in terms of taking possession of and liquidating any assets pledged as collateral. This is often made apparent in the selective regard banks have for collateral, only willing to take pledges on assets that can be easily sold.

1.3. Gender issues relating to SME development

Relatively little research has been conducted on gender issues in SME development within the Asia-Pacific region. One exception is a survey by Global Entrepreneurship Monitor on women and entrepreneurship, albeit on a global level. The most recent such survey, using 2007 data, but published in a 2008 report, spans 41 economies, including just six in Asia: China; Hong Kong, China; India; Japan; Kazakhstan; and Thailand. Based on earlier research, it is posited that "… investment in women's entrepreneurship is an important way for countries to exponentially increase the impact of new venture creation. Ignoring the proven potential of women's entrepreneurial activity means that countries put themselves at a disadvantage and thwart their opportunity to increase economic growth". (Allen and others 2008, 6)

In general, there tends to be a gender gap between male-owned SMEs and female-owned SMEs, although some countries seem to have attained a broad gender balance, including Japan and Thailand (Allen and others 2008, 7). Indeed, in Japan, 2007 saw more women than men starting up new businesses (table 10). That gender asymmetry pertains to both newly established firms and more mature SMEs. Efforts to rectify this asymmetry will, in most cases, need to be country-specific in nature, addressing specific socio-cultural and/or economic factors that are identified as constraining the development of more SMEs owned and managed by women. One example is the United Nations Industrial Development Organization (UNIDO) in Viet Nam, and its project regarding a women's entrepreneurship development programme in the food industry in Central Viet Nam, working in conjunction with the national Women's Union in three provinces:

> In many places in Viet Nam, men traditionally work in the fields and women process the agricultural products. As the economy was opened to the flow of goods from outside, the existence of this traditional occupation for women was put under threat. There are hundreds of women involved in the business of food processing in Danang but many had to give up in the face of severe competition from other products of higher quality. For many of them, a new hope arrived with UNIDO's project that provides skill development in business management, marketing and food processing technology.
>
> A rural resource centre at the Danang Women's Union Vocational Training Center has been established as a functional, active and viable centre where food-processing women entrepreneurs can come for information, training and advice. Entrepreneurial and technology training modules in Vietnamese and English suited to the local needs of women entrepreneurs in the Central Region are in use. Trainers have been trained from the Viet Nam Women's Union and other institutions. Women are organized in self-help groups in order to address specific constraints such as: marketing strategies and competitiveness; access to raw materials, machinery and equipment, technology, finance, training and advisory services. With additional funds from Belgium, the project has recently embarked on the introduction of a lease-purchase service for the self-help groups. The women entrepreneurs are already linked to Belgium's micro credit facility implemented by the Women's Union. (UNIDO 2003)

Another example would be the Micro-Enterprise Development Programme of the United Nations Development Programme (UNDP) in Nepal, which, although not focused

exclusively on women entrepreneurs, has been markedly oriented towards women. Both the central Viet Nam and Nepal projects, and other projects focused on supporting women as entrepreneurs, stem in large part from the Beijing Declaration[13] of 1995, and tend to focus more on micro- and small enterprises, as part of poverty alleviation goals.

Table 10. Prevalence rates of entrepreneurial activity, by gender, across five Asian economies, 2007

(Percentage)

	Early stage entrepreneurial activity		Established business owners		Overall business owners	
	Male	Female	Male	Female	Male	Female
China	19.3	13.4	9.7	7.0	28.9	20.5
Hong Kong, China	14.3	5.8	7.5	3.8	21.8	9.6
India	9.5	7.5	8.7	2.2	18.2	9.7
Japan	3.5	5.2	8.7	8.6	12.2	13.8
Kazakhstan	11.2	7.6	6.8	4.8	18.0	12.4

Source: I. Elaine Allen, Amanda Elam, Nan Langowitz and Monica Dean, *Global Entrepreneurship Monitor 2007 Report on Women and Entrepreneurship* (Global Entrepreneurship Research Association, 2008), available at www.gemconsortium.org.

1.4. Cradle to grave: the role of policymakers and development partners in supporting the SME sector

Policymakers in developing countries and development partners tend to place special attention on SME sector development, for reasons discussed above. In recent years, such interventions have tended to shift away from direct (and often subsidized) support to individual SMEs, which can bring undesired market distorting risks, and more towards economy- and market-wide initiatives that are market-oriented in nature.

Pro-SME development interventions in developing countries tend to focus on those issues where SMEs have most problems of access, including (but not always limited to): (a) access to finance; (b) access to land; (c) access to business support services; (d) access to markets, especially overseas markets; (e) access to training and guidance; and (f) access to technology and infrastructure.[14]

The schema outlined in table 11 tries to profile some of the more common interventions used for pro-SME development, in line with best practice, although it is not exhaustive in scope. In practice, of course, there tends to be quite a lot of overlap between the various components in this SME development smorgasbord.

[13] *Report of the Fourth World Conference on Women, Beijing, 4-15 September 1995* (United Nations publication, Sales. No. E.96.IV.13), chap. I, resolution 1, annex I.

[14] For a cogent summary, see chapter 7 of the *Best Practice Guide for a Positive Business and Investment Climate* (OSCE 2006).

Table 11. Matrix of common SME development interventions

Group	Intervention
Training and information	Encouragement of a culture of entrepreneurship in schools, vocational colleges and institutes of higher education
	Train-the-trainers programmes of various kinds
	SME and business guidance publications of various kinds (on marketing and exporting to overseas markets, for example)
	Applied vocational training for employees of SMEs
	Information technology and distance-learning programmes for SME owners
	Training and guidance tailored for women entrepreneurs
Financial services	Micro-loans and SME-oriented loan/debt products
	Factoring
	Leasing
	Venture capital and private equity
	Angels and angel networks
	Secured transactions and registry
	Guarantee mechanisms of various kinds
	Credit scoring and ratings agencies
	Bankruptcy legislation
Support structures	Incubators (including virtual incubators)
	Clusters and technology centres of various kinds, including those linked to universities
	Business associations
	Infrastructure of various kinds and access to land
	Business-to-business (B2B) portals and e-business platforms
Policy advocacy for a conducive business enabling environment	Private sector and SME development in general, including investment promotion
	Government procurement
	Taxation issues (for example, simplified tax regime)
	Trade issues
	Permitted forms of doing business
	Other regulations in pertinent fields (for example, labour and land, zoning, dispute resolution and contract enforcement)

	Intellectual property rights and other private property rights
	Electronic commerce regulations
	Competition policy and legislation
	Reducing regulatory burdens of various kinds, so as to lessen compliance costs
	Corporate governance
	Corporate social responsibility and sustainable business
Capacity-building	For relevant state agencies (such as conducting regulatory impact assessments or speeding up customs procedures)
	For new and existing business associations, so that they become sustainable
	For providers of business development service (for example accountants, marketing firms, human resources, testing)
	For markets of various kinds
	Within SMEs themselves (such as in management or technical skills, and turning entrepreneurs into successful business people)

Such interventions are typically enacted on a country-by-country basis, coordinated between the relevant government agencies and multiple development partners. There are some examples of regional and subregional initiatives, such as the Mekong Private Sector Development Facility, and the SouthAsia Enterprise Development Facility. Both are multi-donor initiatives managed by the International Finance Corporation, but here too there is often a country-specific approach taken to individual initiatives that are pursued in areas such as the business enabling environment.

Hallberg (2000, 8) is probably right in asserting that:

> An SME development strategy is in reality . . . a "private sector development strategy", recognizing that the majority of firms are small, that they may face different constraints and opportunities than large firms, and that the types of institutions and instruments best suited to their needs may be underprovided in distorted and segmented markets. It points government action toward market-completing interventions and the elimination of policy biases by:
>
> - Addressing the market failures that create cost disadvantages for SMEs, restrict their access to markets, and inhibit the development of markets for a diverse range of financial and non-financial services appropriate for small firms;
> - Improving transactional efficiency in financial, product, and input markets relevant to SMEs, by facilitating access to information and developing mechanisms to manage risk;

- Reconsidering public policies and regulations that discriminate against small firms or produce fixed costs that create a competitive disadvantage for them; and
- Investing in public goods that open market access and build enterprise competitiveness—including infrastructure (information, communications, power, water, and transport) as well as education and technology development.

At perhaps its most "Austrian School"-lite, purist form, this approach almost entails keeping away from quasi-interventionist SME development initiatives per se, and instead focusing on trying to create—and then maintain—the key external enabling factors necessary for competitive SMEs to thrive. These are, most notably: (a) strong property rights protection and contract enforcement; (b) a stable macroeconomic and financial environment, with low inflation and currency convertibility; (c) a competition policy that allows everyone to pursue business opportunities; (d) socio-political stability; (e) regulatory and policy consistency, and an avoidance of "shocks"; (f) tax rates that are not too burdensome; (g) good governance and transparency, including low corruption levels; and (h) robust and competent State institutions for effective implementation and enforcement of all the above.

Of course, this is not a check-list for SME development only, but for a favourable business and investment climate for firms of all sizes and ownership profiles. One can work diligently to overcome a relatively small-scale (but therefore removable) obstacle that is perceived to be constraining SME development, but may have relatively little impact in the big scheme if more generic business environment issues, such as a malfunctioning tax regime (which is much harder to address), go unreformed. Diminishing returns can rapidly set in for pro-SME initiatives that incrementally shave off time or money costs for business start-up procedures, if bigger—and therefore often harder to surmount—obstacles persist.

Another fairly common approach taken by development partners is to support one or more State agencies mandated to coordinate SME-related development policies in a particular country. By building up the capacity of such bodies, it should be possible for the host country itself to lead efforts aimed at creating a more vibrant SME community. But evidence to support the attainment of this objective varies from country to country. One risk here is that the relevant State agencies end up becoming a burden on local SMEs, rather than a source of support. Rather than becoming effective exponents of SME sector development within the government, they burgeon into bodies focused on their own self-sustenance, and divert scarce resources away from the SMEs they are supposed to be helping. Given the choice, most successful SME owners in developing countries are merely looking for a safe and level playing field on which to conduct business, and are not particularly looking for special treatment. Nonetheless, many developing countries have opted to establish SME development agencies of one kind or another, and of varying degrees of effectiveness. However, international development partners should be discerning in their approach to such agencies.

The pursuit of clusters and incubators to support SME development tends to be a relatively large-scale exercise, and one that typically needs a fairly strong degree of private sector involvement to be meaningful and sustainable, and therefore attractive to SMEs. In Viet Nam, for example, the first two incubator projects enacted in Hanoi (agricultural

processing and packaging) and Ho Chi Minh City (software), supported with European Commission funding, have experienced only qualified success. The concept of industry and product clusters has also been attempted in Viet Nam by a few development partners, including the Viet Nam Competitiveness Initiative funded by the United States Agency for International Development (USAID), but the gains derived seem to have been fairly limited, at best. In Mongolia, USAID attempted a cluster development initiative around meat, cashmere and tourism, also without much success. The apparent experience of Viet Nam and Mongolia contrasts with that of markedly more successful incubators and clusters in some other developing and transitional countries, notably in Eastern Europe. This issue will be revisited in more detail in the next section of this report.

In general, one finds policymakers and development partners active in most areas of SME development. The sphere is typically well covered by initiatives of various kinds, with varying degrees of success. As noted above, an area that is typically well supported is removing constraints to market entry, as: (a) this is an important prerequisite of SME development; (b) the interventions required can be relatively simple and attainable; and (c) the positive impact can be easily measured and assessed. The number of approvals required, agency office visits, official and unofficial costs, and days required to start a business (and be compliant with the law in commencing operations) can all be reduced in many developing countries. One-stop shops of various kinds have become a fairly common initiative in this field, even if they consist of multiple entrances, windows and even "back doors". Similarly, the establishment of business associations, commonly along business sector lines, is often pursued, although making such associations genuinely effective and economically sustainable in the long run is not always easy.

In short, such interventions often tend to be "low-hanging fruit" for policymakers and development partners. Conversely, some other, perhaps less readily tangible, factors relating to SME development attract less attention, partly because the positive impact arising is less immediate. But such "high-hanging fruit" may actually have a greater long-term economic development impact, if, for example, it allows local SMEs to establish greater linkages with the foreign investment enterprise community, or to export much better. As a consequence, such interventions can have a greater impact on, among other things, employment (and poverty alleviation), foreign exchange earnings and addressing socio-economic and gender imbalances of various kinds. In other words, supporting SMEs that they may graduate from survival to competitive (or sustainable) status. Having navigated through the market entry process, an SME may survive for quite some time, without really attaining a level where it can be deemed a success. This is where SME support is perhaps most necessary in many developing countries, but also harder to achieve (and measure). Sections 2 and 3 of this report focus largely on this aspect. Section 4 of the report includes some specific policy recommendations on alternative SME development initiatives that could reap dividends.

2

GLOBALIZATION OF PRODUCTION AND THE COMPETITIVENESS OF SMEs IN ASIA AND THE PACIFIC: TRENDS AND PROSPECTS

2.1. The setting

The focus of this section is on the trends and prospects for the competitiveness of the region's SMEs, based on a review of the literature (as distinct from original research). In this context, the key dynamic shaping the prospects of Asia-Pacific SMEs relates to the globalization of production. This is changing the competitive environment for the region's SMEs in both international markets and at home. Therefore, at the core of the story is the need to understand the nature of globalization and its implications for the competitive performance of Asia-Pacific SMEs. From this perspective, small traditional firms serving only small local markets are not of primary interest here, except insofar as they may evolve, or may be forced to evolve, into competitive enterprises in the above context.

As discussed in section 1, there is no consensus on the definition of SMEs; it differs among the economies of Asia and the Pacific with regard to common indicators, such as the number of employees, invested capital, sales volume and revenues, or production capacity. However, two common characteristics of SMEs in the region are: (a) the majority are small, employing fewer than 100 people; and (b) they typically make up over 90 per cent of registered enterprises in any given economy.

It is generally recognized that SMEs play an important role in Asia-Pacific economies in terms of employment and value added, despite the disadvantages of both size and relative sophistication of their operations. However, estimates of their actual contribution to their respective economies in the region vary greatly (see, for example, estimates from the Asian Productivity Organization in table 12). In general, SMEs are seen as supporting competitive and flexible markets through relative ease of entry and exit, and through their role as subcontractors, which supports the restructuring of both public and private enterprises in the region. They are also seen as making important contributions to poverty alleviation, since SMEs often employ poor and low-income workers, frequently providing the primary source of income in lagging regions and rural areas.

Table 12. SMEs among total enterprises, contribution to employment, and total value added, in selected Asia-Pacific economies

(Percentage)

	China	India	Indonesia	Japan	Malaysia	Philippines	Republic of Korea	Thailand
SME establishments	99.7	95.0	100.0[a]	99.0	94.4	99.6	99.0	98.0
Employment	74.0	80.0	99.0	88.0	40.4	69.1	69.0	55.8
Value added	60.0	40.0	63.1	56.0	26.0	32.0	46.0	47.0

Source: Mark Goh, "High-growth, innovative Asian SMEs for international trade and competitiveness: challenges and solutions for APO member countries" (Tokyo, Asian Productivity Organization, 2007), p. 3, available at www.apo-tokyo.org/rr_papers/index.htm.

[a] Actual figure is 99.995 per cent.

There are significant differences in the nature and role of SMEs in the diverse economies of Asia and the Pacific. Many SMEs are in the retail and service sectors, characterized by relatively low-level and stable technology and scale, and generally static performance in local markets. Other SMEs are internationally oriented subcontractors to large enterprises, at varying levels of sophistication of skill and technology. Still others are dynamic entrepreneurial firms active in key new product and service niches, including dynamic start-ups commercializing new products and technologies. As Lall (2000b) notes, the proportion of "modern" SMEs competing on the basis of sophisticated technologies and products varies significantly among the economies of the region.

Very broadly, there is a dualistic pattern of SME development in the Asia-Pacific region, with a small relatively dynamic and competitive SME sector co-existing with a much bigger number of under-performing SMEs. A large proportion of Asia-Pacific SMEs: (a) remain in traditional activities; (b) are characterized by low levels of productivity, relatively simple technology and poor quality products; and (c) compete in small, local markets. A much smaller group has taken advantage of new opportunities offered by globalization, upgrading their products and production processes, entering new product markets, and expanding their domestic market shares. Ayyagari, Beck and Demirguc-Kunt (2003), in reviewing the contribution made by SMEs to economies in 76 countries, observed the following relationship between the contribution that SMEs make to GDP and national income: in high-income countries, 51 per cent of GDP was produced by SMEs; in medium-income countries, 39 per cent (this context also includes the more advanced economies of East and South-East Asia); and in low-income countries, only 16 per cent.

For example, SMEs play an important role in job creation in the economies of China, Japan, India, Indonesia, Taiwan Province of China and Viet Nam, where they contribute over 70 per cent of employment, as compared with Malaysia and Thailand, where SMEs contribute less than 60 per cent of employment. The participation of the region's SMEs in international trade, and therefore the extent of their global integration, also differs widely; export orientation in China, the Republic of Korea, and Taiwan Province of China is rather stronger than that in India, Indonesia, Malaysia and Thailand.

However, this aggregate picture can be somewhat misleading. SMEs based in Penang play a critical role in Malaysia, providing an important foundation for that country's participation in the global economy in terms of competitive performance in the information, communications and technology (ICT) and electronics sector. In Singapore, SMEs have a relatively modest presence in terms of the number of establishments and contribution to employment, yet they play a key role in diversifying the production structure of the economy and in attracting large multinational enterprises (MNEs, also known as multinational corporations) to the supplier clusters they provide. In China and Viet Nam, SMEs have played an important role in the transition from a centralized planned economy to one that is more decentralized and market-oriented, and in the building of a vibrant domestic business sector. In Taiwan Province of China, SMEs have been critical in the country's dramatic and sustained overall economic transformation and development. A summary profile of the diverse role of SMEs in the member economies of the Asia-Pacific Economic Cooperation forum is presented in table 13.

Table 13. A summary profile of SMEs in East Asia/the Asia-Pacific Economic Cooperation forum

	Key features	Regional differences and policy issues
Number of enterprises	1. There are about 20 million to 30 million SMEs in East Asia. 2. They account for 98 per cent of all enterprises. 3. Microenterprises account for about 73 per cent of all private sector enterprises. 4. On average there are about 85 people for every SME.	1. Most of the SMEs are in China (8 million), Japan (5 million) and the Republic of Korea (2.6 million), which together are home to 70 per cent of the SMEs in East Asia. 2. In developed economies there are only about 20 people per SME, but the ratio is above 100 in the developing economies, especially in China, Indonesia, the Philippines and Viet Nam.
Employment	5. SMEs employ about 60 per cent of the private sector workforce, and 30 per cent of the total workforce. 6. Microenterprises employ about 21 per cent of total APEC-wide employment. 7. Over 95 per cent of enterprises employ fewer than 100 people, and over 80 per cent employ fewer than five people. 8. SMEs contribute about 70 per cent of net employment growth. 9. SMEs provide about 80 per cent of employment in the services sector, and about 15 per cent in the manufacturing sector. 10. Women make up about 30 per cent of employers/self-employed in APEC—mainly in microenterprises	3. In developing economies (below about $15,000 per head income) SMEs employ about 75 per cent of people; above $15,000 the level is closer to 50 per cent. Japan is a major exception—SMEs there employ about 80 per cent of the workforce. 4. More developed economies seem to have more medium-sized SMEs, and such SMEs play a greater role. Developing economies seem more likely to have a “missing middle”. 5. In developed economies, most of this growth probably comes from fast-growth firms; in developing economies a higher proportion probably comes from net start-ups.
Output measures (such as sales and value added)	11. SMEs contribute about 50 per cent of sales, value added or output.	6. The contribution varies from lows of 15 per cent (Singapore) and 30 per cent (Australia) to about 60 per cent for most other economies.

	Key features	Regional differences and policy issues
Exports	12. SMEs generate about 30 per cent of direct exports ($930 billion in 2000), much less than the SME contribution to employment (about 60 to 70 per cent) or output (about 50 per cent). 13. SMEs contribute indirectly to trade through supply chain relationships with other firms. SME contribution to total trade could rise to 50 per cent.	7. SME exports figures are difficult to verify, but they range from about 5 per cent or less (Indonesia) to about 40 per cent (Republic of Korea) of total exports. 8. Tariff cuts have increased total APEC member trade, but the SME contribution to direct exports has remained static or declined. Reductions in tariffs have not benefited SMEs; more emphasis needs to be put on tackling non-tariff barriers if SMEs are to benefit from trade expansion.
Foreign direct investment	14. SMEs generate about 50 per cent of the cases of foreign direct investment, but less than 10 per cent of the value of such investment.	9. SMEs in Japan, the Republic of Korea and Taiwan Province of China contribute most foreign direct investment originating in the East Asian subregion.
Entrepreneurial engine, international potential, and the new economy	15. SMEs already contribute the bulk of growth, and could make a much larger contribution to the Asian regional economy if efforts were made to address impediments to SME internationalization. This could add as much as $1.18 trillion in trade over a five-year period. 16. SMEs are moving towards services and away from agriculture and manufacturing.	10. The developing economies need to create about 50 million to 70 million more SMEs if they are to achieve “benchmark” levels of SME activity. 11. To achieve maximum gain from trade it is essential to improve governance with regard to building capacity, reducing transaction costs, promoting further liberalization, addressing non-tariff barriers, increasing Internet access and facilitating trade and investment to improve the capacity of SMEs to export.

	Key features	Regional differences and policy issues
		12. Capacity-building includes: access to finance; improved professional skills (information technology, management, accounting and entrepreneurship); improved business infrastructure; and removal of trade barriers that particularly and adversely affect SMEs. 13. E-commerce use by SMEs lags larger enterprises; e-commerce is important for cost saving and growth potential. The usage of technology is a problem due to set-up and usage costs, and a lack of adequate infrastructure and information technology skills.

Source: C. Harvie, "East Asian SME capacity building, competitiveness and market opportunities in a global economy", Economics Working Paper Series, WP 04-15 (University of Wollongong, August 2004), table 8, p. 13.

Abbreviations: APEC, Asia-Pacific Economic Cooperation; SMEs, small and medium-sized enterprises.

As noted in table 13, the corporate landscape of many emerging economies in Asia and the Pacific often exhibit a "missing middle" of competitive SMEs. These economies tend to comprise a relatively small number of large enterprises, and a large number of small, often uncompetitive and static traditional SMEs serving small, local markets (see, for example, Freeman 2008 on Viet Nam). In a global economic environment characterized by trade liberalization, rapidly changing technology, and growing and changing demand for higher quality and differentiated intermediate and final products and services that meet a variety of stringent international standards, traditional SMEs find it difficult to make the upgrades they need to stay competitive even in their domestic markets. Therefore a key challenge facing SMEs and the related role of governments in Asia and the Pacific is to strengthen SME competitiveness in both domestic and international markets, to "fill the missing middle".

2.2. SMEs and competitiveness

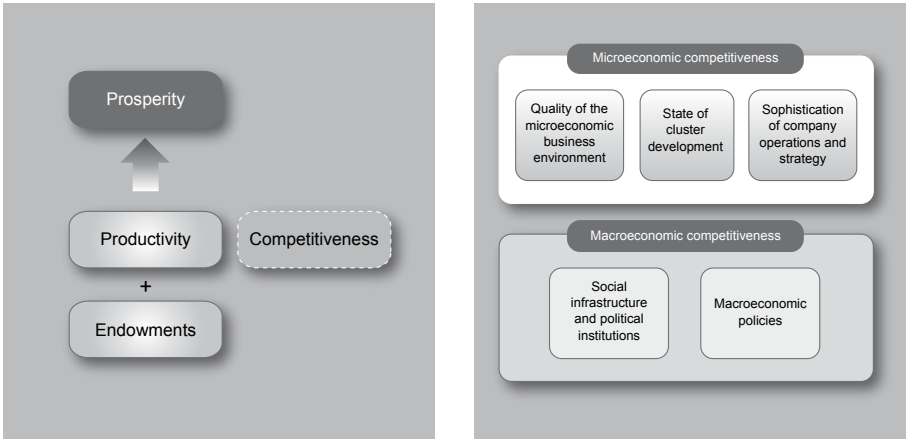
2.2.1. Concept of "competitiveness"

The concept of "competitiveness", although widely used, can be elusive and subject to considerable debate. In the context of enterprises, the meaning of competitiveness, as well as competitive strategy, is relatively clear. It refers to the ability of firms to compete for markets, resources and revenues, as measured by indicators such as relative market share, growth, profitability or innovation (see, for example, Roberts 2004; Greenwald and Kahn 2005). However, extending the concept from enterprises to economies is subject to considerable debate. Representing nations as competing with each other in world markets, and becoming more competitive or less competitive as economies has been called a "dangerous obsession", reflecting a misunderstanding of the basic theory of comparative advantage that explains gains from specialization and trade (Krugman 1994).

Partly as a response, competitiveness is generally approached as a multilevel concept where national competitiveness is closely linked to enterprise competitiveness (see, for example, UNCTAD 2005b); Porter and others (2008)). A typical definition of competitiveness at the national level refers to "a nation's ability to produce goods and services that meet the test of international markets while simultaneously maintaining and expanding real incomes of its people over the long term" (United States Presidential Commission on Industrial Competitiveness, in UNCTAD 2005b, p. 3). National competitiveness, in turn, is seen as a function of a country's: (a) endowments (such as land, labour and capital); (b) macroeconomic conditions, including a country's policy and institutional environment; and (c) microeconomic factors, including the quality of a country's business environment, the relative sophistication of firms' operations, and the state of a country's enterprise cluster development (see, for example, Porter and others 2008). This is the general framework used in the rankings for the World Competitiveness Index noted above (see also table 5).

From this perspective, the competitiveness of an economy is seen as ultimately reflecting its productivity. This, in turn, depends on the value of a nation's products and services, supplied by its enterprises, as measured by the prices they command on international markets, and the efficiency with which these products and services are produced (UNCTAD 2005b; Porter 2008). An economy becomes more competitive through its ability—or, more precisely, through the ability of its enterprises—to increase productivity by using assets (human resources, capital, physical assets, among others) more efficiently. This, in turn, is shaped by a country's endowments, macroconditions, and microfactors (figure 2). Therefore, getting macrofundamentals right is necessary but not sufficient for strengthening a nation's competitiveness if, for example, the country's business environment and/or the quality and operations of its enterprises are weak. At the same time, a lack of physical endowments need not be a binding constraint. Singapore overcame such constraints to become one of the most productive or "competitive" economies in the world through effective policies and institutions that developed its human resources and attracted foreign investment.

Figure 2. Competitiveness and productivity



Source: M. Porter, M. Delgado, C. Ketels, and S. Stern, "Moving to a New Global Competitiveness Index", in Michael E. Porter and Klaus Schwab, eds., *Global Competitiveness Report 2008-2009* (Geneva, World Economic Forum, 2008), figures 1 and 2, p. 45.

Competitiveness is then ultimately an enterprise-level concept, referring to the relative performance of firms in particular product markets. It is the ability of a country's enterprises to sustain superior market positions and profitability relative to their domestic and international competitors by producing products and services of superior quality and functionality, at competitive prices, delivered on time to both domestic and international buyers. Dynamic competitiveness—competitiveness over the longer term—refers to the ability of enterprises to respond flexibly, quickly and in a sustained manner to changes in demand, technology and resource availability and to the actions of competing firms. This can be achieved through adjustments in, among other things: (a) the efficiency of the production process; (b) product differentiation; and (c) innovative capacity, including both process and product innovation, and by developing entirely new markets for existing and new products.[15]

In summary, many interacting factors, at different levels, shape the competitive performance of an enterprise, including: (a) its resources (people, skills, physical capital and technology, among other things); (b) its market power, for example through branding and customer loyalty; (c) its capacity to respond effectively to competitors, including to potential substitutes for its products; (d) its capability and flexibility to respond to changing circumstances, for example in the availability of key resources, capacity for process and product innovation; (e) its capability to create new market niches; (f) the business environment which conditions its performance, such as the process of business licensing that controls ease of entry (see, for example, Freeman 2008); (g) the policy and regulatory environment, for example tax policy, competition laws and export/import procedures; and (h) supporting services provided by both public and private organizations, for example

[15] In this context, non-price competitiveness is potentially more important in the long run than price competitiveness. It allows an enterprise to shift the demand curve for its products and services outward, instead of simply moving the demand curve down through lower costs and prices (ADB 2003).

the quality of physical infrastructure and logistics systems, and both general and specific skill-related education services.

2.2.2. Competitiveness and exports

Traditionally, performance on international markets, or export competitiveness, is often taken as the key indicator of competitiveness. Export performance is seen to reflect the ability of domestic enterprises to compete on international markets as measured in terms of the scale of exports, relative prices commanded by domestic firms, diversification of exports, and the (changing) technology and skill content of exported products and services. The rationale for exports as the key indicator of competitiveness includes:

- Export price and demand is perceived as less influenced by Government policies, and therefore may be a more appropriate reflection of actual enterprise competitive performance;
- Exports provide key information essential for the competitiveness of enterprises (and therefore economies), for example on technology, on market demand and on leading competitors in the industry;
- Exports allow for scale economies, which can be a critical factor in enterprise competitiveness.

The global environment is changing in fundamental ways—including the very nature of exports. This has important implications for the competitive performance of enterprises in general, and SMEs in particular, in both domestic and international markets. It is a world characterized by policy liberalization, accelerating technological change, more intense and diversified market demands, and increasing mobility of capital, all leading to a more complex and demanding competitive environment at home and abroad. Traditional modes of competition based on low costs and prices are no longer sufficient for sustained success, as global production is characterized by large shifts in location, patterns of comparative advantage, and in the structure of global industries. The new competition in a widening range of product markets is more intensive and is waged over a wider range of factors, in both export and domestic markets. Price continues to be important, but competition and the prospects of firms are increasingly driven by factors such as: (a) the capacity to meet a variety of stringent global product and process standards; (b) flexibility and innovation; (c) design and differentiation; (d) reliability and timeliness; and (e) networking—the capacity to collaborate and/or form strategic alliances and partnerships with both similar firms and vertically linked enterprises.

The basic competitive challenge to Asia-Pacific SMEs in the emerging global environment is how to participate in global markets in a way that leads to sustained income growth. This is a twofold challenge: (a) Can SMEs participate effectively in production for regional and global markets, as well as in their home markets?; and (b) Can they achieve sustained income growth by upgrading over time through product and process innovation that increases pricing power and value creation? A related third challenge is: If domestic SMEs cannot or choose not to access international markets, is the emerging global environment changing the way they have to do business at home? Before looking more closely at the changing global environment and its implications for the competitive performance of Asia-Pacific SMEs, it is useful to touch briefly on the traditional constraints on SME competitive performance.

2.2.3. Traditional constraints on the competitiveness of Asia-Pacific SMEs: an overview

The competitive performance of Asia-Pacific SMEs has been constrained by a range of well-known and studied factors (see, for example, Asasen, Asasen and Chuangcham 2003; Beck 2007; Harvie and Lee 2003; Ferranti and Ody 2007; Goh 2007; Lall 2000a). They include the following:

- Small firms are generally faced with higher costs in purchasing inputs such as equipment, raw materials, finance and business services. Smaller enterprises do not have the scale and/or bargaining power of larger firms;
- SMEs are characterized by limited managerial capacity and skills in areas such as operations management, accounting, financial management, marketing and strategy;
- Small firms are constrained by their ability to obtain information on potential markets and buyers. ICT can, in principle, loosen these constraints. However, Internet and e-commerce use among Asia-Pacific SMEs is generally lagging behind larger enterprises because of factors such as high set-up costs, lack of adequate infrastructure, and scarcity of ICT skills;
- SMEs are limited in their capabilities to respond to market opportunities in terms of meeting demands for large volumes, standards and certification, and regularity of supply. For example, the transaction costs of large buyers in dealing with many SMEs are very high, limiting their interest in sourcing from many individual small firms; while SMEs find it difficult to meet the requirements and costs of certification necessary for the standards demanded by such buyers;
- SMEs are faced with constraints in accessing factors and support services such as training and skill development, market intelligence, logistics, technology and financing. For example, with respect to human resource needs, basic education and in-firm training is no longer sufficient, as the emerging competitive setting requires increasingly higher levels of specialized training. Constraints on accessing financing are particularly important, limiting the capacity of small firms to invest in upgrading their skills and capabilities, to grow, and, more fundamentally, to meet the working capital needs necessary to carry on their day-to-day operations;
- Regulatory and policy environments often impose limitations and high fixed costs on SMEs. In comparison with larger firms, they generally demand a higher proportion of a small enterprise's resources on a continuing basis—including management time—for learning rules and regulations, and for modifying operations for compliance with such regulatory requirements.

These traditional constraints on the competitive performance of Asia-Pacific SMEs generally become even more pronounced (sometimes in modified form) in the context of the challenges of globalization, which, in turn, also poses new challenges for the competitiveness of enterprises.

2.3. Competing in a changing global economy

2.3.1.Drivers of a changing global economy

Globalization is the product of political, economic, and technological forces that have accelerated since the early 1980s. The focus here is on the nature and effects of globalization involving changes in the organization and location of the production of goods and tradable services. From this perspective, globalization is transforming the nature and location of international production, trade and investment (see, for example, Baldwin 2006a, Dicken 2007, and Grossman and Rossi-Hansberg 2006). In the process, it is changing the competitive environment for business in general, and for Asia-Pacific SMEs in particular, bringing significant new opportunities, as well as increasingly intense competition and new challenges. The key drivers of (economic) globalization include the following:

- *Policy liberalization,* which is: (a) reducing import, export and investment constraints; (b) providing new options for the geographic location of production; and (c) integrating and expanding fragmented markets for both intermediate and final products, and in the process is creating regional and global opportunities for firms, including SMEs;

- *Accelerating technological change,* which, in areas such as transport, telecommunications and information technology, supported by managerial innovation for coordination: (a) lowers costs; (b) reduces distance and time; (c) extends the reach of firms; and (d) allows the simultaneous fragmentation, geographic dispersion and coordination of production;

- *Increasing mobility of capital,* which is diversifying options for competitive local producers. Foreign direct investment is taking advantage of cross-border factor cost differences and local supplies of technology and skilled personnel; it is also providing new opportunities for domestic SME suppliers. At the same time, increasing portfolio capital flows can loosen constraints on financing for potentially competitive domestic enterprises;[16]

- *Demands of increasing competition,* which are creating simultaneous pressures for lower cost, higher quality, shorter delivery time and wider choice, thus changing the structure of industries. In some cases, this is leading to increasing consolidation for competitive scale (for example in semi-conductors and pharmaceuticals), and, in many other cases, to greater fragmentation and geographic diffusion of production (for example in electronics/ICT). In an increasingly fragmented global production environment, competition is becoming less restricted to individual enterprises, and more observable between networks of linked firms that include SMEs as key suppliers (for example Nokia + its network of suppliers vs. Motorola + its networks of suppliers).

[16] The risks of the increasing mobility of capital and integration of capital markets is well understood in an Asia that still vividly remembers the experience of the "Asian Crisis" of the late 1990s, and that is presently experiencing the on-going global financial crisis triggered by the subprime problem in the United States, which has significantly constrained the availability of global credit.

As a consequence of these broad drivers of change, the number of products and tradable services that are conceived, manufactured and consumed entirely in one country—or in one enterprise—is rapidly shrinking. Globalization is reducing the dominance of any single location in the production process. International production is increasingly organized in the form of global value chains (GVCs) and related international production networks (IPNs) that together present new forms of integration into the global economy for enterprises and economies.[17]

2.3.2. Globalization of production: selected issues[18]

Organization of international production. Global value chains and associated production networks are emerging as the organizing framework for production, investment, and trade in an expanding range of product groups, such as garments, agro-industry, furniture, automobiles/auto parts, consumer electronics, telecommunications and ICT, as well as services (see UNCTAD 2002). This has resulted in increased task- and/or product-related specialization by firms in the production of goods and services, and a corresponding acceleration of growth in intra-industry and intra-product trade, as compared with traditional trade in final products. However, it should be noted that, while specialized and fragmented production (integrated through global value chains and production networks) is a key dynamic driving the evolution of international business, there are firms that compete effectively on global product markets with widely different organizational strategies, retaining a range of activities in-house and/or onshore.[19]

Opportunities for SMEs. The trend, however, has been toward the GVC/IPN framework for organizing international production. Although many MNEs continue to provide a variety of products and services on global markets, they now increasingly purchase inputs and components from smaller companies (SMEs) in widely dispersed locations that serve particular industry niches. Global export markets increasingly involve exports of parts, components and services within the framework of GVCs and associated production networks. In this context, many companies, particularly smaller enterprises, are finding that success and "creating value" may be achieved through specialization in a limited set of activities, outputs and market niches. For example, even simple components such as radiator caps can be produced for regional and global markets by a supplier in the production networks of Toyota or Ford Motor Company. Specialized niche markets, such as organic fruit and vegetables, can be regional and even global in nature through access to global retailers such as Carrefour or Tesco. Two dimensions of particular importance to SMEs in the context of GVCs/IPNs relate to the key role of global standards and the emergence of new types of enterprises for organizing global production.

Role of standards. Product and process standards are increasingly shaping production, especially within the framework of global value chains. There is growing pressure in key markets, such as the United States and European Union, for global producers to adjust their operations to reflect not only profitability, but also social and environmental objectives (corporate social responsibility requirements, for example). In addition, within the framework of GVCs, standards play the key role in ensuring product

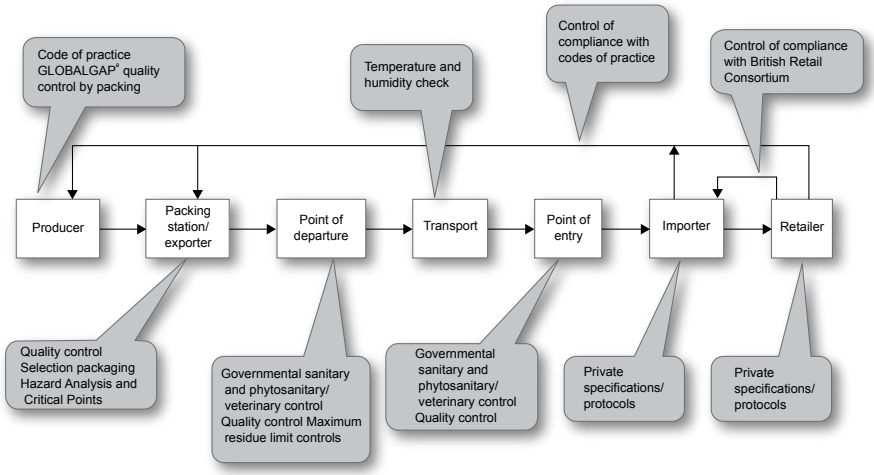
[17] See Abonyi (2007) for an introduction, discussion and examples of the concepts of global value chains and related international production networks.

[18] Based on Abonyi (2007).

[19] Examples include Intel in ICT/electronics, and Zara in apparel/garments.

and process consistency and reliability along the chain (figure 3). Therefore, producers wishing to participate within GVCs increasingly have to meet the stringent requirements of a growing multiplicity of standards in a wide range of industries (wood furniture, automobiles and electronics, among others). Meeting a multiplicity of strict global standards is of particular challenge to SMEs, given their general constraints. Examples of the diversity of standards include: (a) internationally agreed standards, such as ISO 9000 (quality), ISO 14000 (environment), SA 8000 (labour) and G3 for cellular phones; (b) industry-specific standards, such as phytosanitary standards and hazard analysis and critical point in the food industry; (c) region-specific standards, such as QS 9000 (quality in autos originating in the United States); and (d) firm-specific standards, supporting brand names (for example, the Volkswagen quality standard, Carrefour's in-house brand standards).

Figure 3. Food safety and quality standards in the global value chains for fresh fruit and vegetables



Source: Sabine Willems, Eva Roth, Jan van Roekel, "Changing European public and private food safety and quality requirements: challenges for developing country fresh produce and fish exporters", World Bank Agriculture and Rural Development Discussion Paper (Washington D.C., World Bank, 2005), p. 23.

[a] Formerly known as EurepGAP.

Emergence of global suppliers. Lead firms in a growing number of industries are becoming increasingly reliant on global suppliers, often based close to home but supported by subcontractors globally, to organize international production. This spreads the risks and lowers the costs of doing business for lead firms. Global suppliers, in turn, are reorganizing networks within value chains, redefining the role and relationships of lower-level suppliers/producers further back in the chain. In this context, lead firms and their supporting global suppliers are increasingly looking for firms that already have the requisite production capabilities, not firms that need to be brought up to required standards—posing new challenges to both enterprises and governments in the Asia-Pacific region. This reorganization of networks, although most pronounced in electronics and automotives, is becoming a factor in an increasingly wider range of industries. Examples of global suppliers include Flextronics International in electronics/ICT and Li

& Fung in apparel/garments. As a consequence, global suppliers are emerging as key global investors, with significant influence on the export competitiveness of host countries and on the fortunes of SMEs, as reflected in the Flextronics investment in a major industrial park in Chennai, India. These global suppliers, whose core strategic function includes integrating production across borders, are looking for domestic suppliers with internationally competitive capabilities, as well as support systems that facilitate the smooth, continuous exchange of parts and components (well developed logistics systems and efficient import/export procedures, for example).

Central role of trade facilitation in the global supplier system. Within the framework of global value chains, a central challenge of integrating production involves shipping products, particularly parts and components, among geographically distributed production sites. Ensuring the ease of the import and export of products and services in the context of particular global value chains and networks is of critical importance for the competitive performance of domestic enterprises in individual economies. This is particularly important for SMEs as existing and/or potential suppliers within the framework of global value chains and production networks. This relates to the efficiency and effectiveness of a country's logistics systems and its import/export procedures in the context of specific value chains where domestic enterprises are active. Returning to the *Doing Business 2009* survey, one of its 10 components ranks countries on the procedural requirements for export and import standard goods, in terms of: (a) the number of documents required; (b) the time required; and (c) the cost entailed. Table 14 shows the results for the Asian-Pacific economies included in the survey.

Table 14. *Doing Business 2009:* exporting and importing in Asia and the Pacific

Economy	Documents for export	Days to export	Cost to export one container (US$)	Documents for import	Days to import	Cost to import one container (US$)
Average for East Asia and the Pacific	6.7	23.3	902	7.1	24.5	948.5
Average for South Asia	8.5	33.0	1 339	9.0	32.5	1 487.3
Afghanistan	12	74	3 000	11	77	2 600
Australia	6	9	1 200	6	12	1 239
Azerbaijan	9	48	3 075	14	56	3 420
Bangladesh	6	28	970	8	32	1 375
Bhutan	8	38	1 210	11	38	2 140
Brunei	6	28	630	6	19	708
Cambodia	11	22	732	11	30	872
China	7	21	460	6	24	545
Fiji	13	24	654	13	24	630
Hong Kong, China	4	6	625	4	5	633

India	8	17	945	9	20	960
Indonesia	5	21	704	6	27	660
Japan	4	10	989	5	11	1 047
Kazakhstan	11	89	3 005	13	76	3 055
Kiribati	6	21	1 070	7	21	1 070
Kyrgyzstan	13	64	3 000	13	75	3 250
Lao People's Democratic Republic	9	50	1 860	10	50	2 040
Malaysia	7	18	450	7	14	450
Maldives	8	21	1 348	9	20	1 348
Marshall Islands	5	21	875	5	33	875
Micronesia (Federated States of)	3	30	1 255	6	30	1 255
Mongolia	8	49	2 131	8	49	2 274
Nepal	9	41	1 764	10	35	1 900
New Zealand	7	10	868	5	9	850
Pakistan	9	24	611	8	18	680
Palau	6	29	1 170	10	33	1 132
Papua New Guinea	7	26	664	9	29	722
Philippines	8	16	816	8	16	819
Republic of Korea	4	8	767	6	8	747
Samoa	7	27	820	7	31	848
Singapore	4	5	456	4	3	439
Solomon Islands	7	24	1 011	4	21	1 194
Sri Lanka	8	21	865	6	20	895
Taiwan Province of China	7	13	757	7	12	769
Tajikistan	10	82	3 150	10	83	4 550
Thailand	4	14	625	3	13	795
Timor-Leste	6	25	1 010	7	26	1 015
Uzbekistan	7	80	3 100	11	104	4 600
Vanuatu	7	26	1 497	9	30	1 392
Viet Nam	6	24	734	8	23	901

Source: World Bank, *Doing Business 2009* (Washington D.C., 2009).

These country figures are quite striking in their diversity, but the basic message in the context of this paper is clear. A SME operating in a country that takes more than 10 times longer than another country to go through the regulatory steps to export a single container is at a substantial disadvantage when serving international customers. This is true for a wide range of industries, from garments to electronics/ICT, where the anticipated delivery cycles have become remarkably short, delays are not readily tolerated, and the ability to meet tight deadlines is a key determinant in attracting (and retaining) customers.

Similarly, an SME is at a clear competitive disadvantage if it operates in a country where the cost to export a single container is eight times higher than it is than another country. Typically, that additional cost will have to be absorbed by the SME, in a lower price per item, to mitigate the additional shipping costs incurred, if at all possible.[20] That in turn lessens considerably the profit margin and potentially the viability of the enterprise. Even for an SME that does not export its output, but relies on imported inputs, higher shipping costs will lower the threshold of profitability.

Furthermore, multinational enterprises contemplating where to invest in a new plant (Flextronics in electronics/ICT, for example), or from where to source (Li & Fung in apparel and garments, for example) will also consider these trade costs and time issues when seeking supplier locations. Thus, for SMEs in the host country aspiring to establish business linkages with foreign-invested projects in the context of expanding domestic markets, the cost and time of exporting and importing can have an impact, even if their own businesses entail absolutely no external trading activity. Put another way, pro-SME efforts expended in this field will have a positive impact far beyond SMEs alone, and can even help in attracting foreign direct investment (FDI) inflows.

One indicative example is that of Intel in Viet Nam. Intel, a specialized and important global supplier in the electronics/ICT industry, manufactures and ships parts and components globally from geographically distributed locations. It recently decided to build a $1 billion chip-assembly plant near Ho Chi Minh City. Upon completion, the chip plant will undoubtedly wish to locally source a number of inputs—both products and services—from Vietnamese companies.

Intel's decision to locate its newest Asian chip plant in Viet Nam was taken despite the fact that the country's port infrastructure is becoming heavily congested. This is because, fortunately for Intel (and Viet Nam), the wafers that the plant will process can be imported by air, and not by sea. Nonetheless, Intel cannot afford to face delays with shipping, given the time sensitivities of its own clients. As a result, it has embarked on a project to assist the customs authority of Viet Nam to introduce an e-customs platform, operating 24 hours a day, seven days a week. This e-customs initiative is possible because: (a) Intel's investment is so large that technical assistance of this kind is a viable proposition; and (b) the host country Government was willing to make additional commitments in order to attract Intel's $1 billion investment. However, this is not true of

[20] The case of IKEA is a good example of this issue. Principally based in Europe, IKEA sources products for its stores from around the globe, and has offices located in numerous countries to fulfil this sourcing function. In cases where two IKEA sourcing offices in different countries are both able to contract a respective local firm to produce a particular item of similar quality, then the main determining factor is price. But it is not the price of the item in the country of manufacture, but the price on arrival in Europe, including shipping costs, that matters. So, if an SME in country A can ship the item to Europe for less than an SME in country B, simply due to lower container or port costs, for example, then the SME in country B has no choice but to provide the same item at a lower price, to offset the higher shipping costs it faces.

most foreign-invested projects, which tend to be smaller in scale and less high profile in nature. Thus, the combination of congested ports and unreliable customs procedures could well prompt a potential investor to select a different country to host a new plant. If this had happened in the case of Intel and Viet Nam, one can only speculate on the significance of the loss for some Vietnamese SMEs, in terms of a lost opportunity to establish linkages with and learn from a leading global technology company.

As the international production system evolves, the key role of GVCs and IPNs in a growing number of industries provides an increasingly effective mechanism for Asia-Pacific SMEs to access global and regional markets as suppliers within global value chains and associated networks. The globalization of production therefore offers Asia-Pacific SMEs new opportunities for internationalization beyond the traditional export of final goods. These enterprises can be suppliers to MNEs outside their home countries as exporters of parts and components, and they can also be domestic suppliers to exporting MNEs in the domestic market—provided they meet the required global standards. However Asia-Pacific SMEs choose to participate in such value chains and networks, they must be able to deliver a specified product, in the right quantity, with the required quality, at the right time and meet an expanding range of increasingly stringent global market standards, for example on labour conditions and the environment. The payoffs from participating in GVCs and IPNs can be potentially high for SMEs, but generally so are the requirements for entry.

2.3.3. Impact of the globalization of production on East Asian enterprises[21]

The impact of the globalization of production in Asia and the Pacific has been most pronounced to date in East Asia (including, as used here, South-East Asia).[22] Expanding trade between East Asia and the rest of the world has reflected the region's growing importance in the global trading system. East Asia's share of world trade has increased from about 10 per cent in the 1970s to more than 25 per cent in 2006, overtaking the North American Free Trade Agreement's share of about 20 per cent (though still lagging the European Union's share of around a third of world trade). This interregional trade is dominated by final goods, primarily for key markets such as the United States and the European Union. However, the region's demand for its final products is expected to continue to expand in the future, as there is an increasing focus on domestic consumers and markets.

Market-driven trade and investment integration has moved forward in East Asia without formal intergovernmental or region-wide agreements; it has, however, been facilitated by (mostly ad hoc) policy liberalization. Intraregional trade has expanded as a share of the region's total trade, increasing from about 35 per cent in 1980 to over 55 per cent by 2006.[23] This is driven by the growth of intra-industry trade in parts and components; the share of which in total regional trade is estimated to have increased from 55 per cent in 1990 to 78 per cent by 2005. Export profiles of countries increasingly match import profiles of other economies in the region, reflecting growing production complementarity and integration. Supporting trade expansion and integration, FDI to East

[21] See Abonyi (2008) for a discussion of the integration of East Asian production in the more general context of Asian integration and cooperation.

[22] There are also significant links to global value chains from suppliers in other parts of Asia and the Pacific, for example, garment producers in Bangladesh; sports equipment and surgical instruments from Pakistan (Sialkot); and particularly business services from India. However, as a subregion, the participation and integration of East (South-East) Asian producers has been the most pronounced and advanced to date.

[23] See IMF (2007) and ADB (2007).

Asia has expanded even faster, from 7 per cent of total world FDI inflows in 1980 to 13 per cent in 2006; with outflows also increasing to 12 per cent of world total outflows (up from 5 per cent) over this same period (UNCTAD 2008). Much of the FDI flows are intraregional, for example from Japan and newly industrialized economies to the Association of Southeast Asian Nations (ASEAN) and China, as well as intra-ASEAN and from ASEAN to China; this further strengthens the regional economic integration process. The result is an increasingly integrated East Asian economy of expanding *intra*regional trade dominated by parts and components, feeding growing *inter*regional trade of final goods with markets in North America and the European Union.

Table 15. Expansion of intra-East Asian trade, 1990-2005: the example of machinery and machine parts

(Percentage)

Exports		*Parts and components*			*Machinery final goods*			*Total*		
		Share		*Real growth*	*Share*		*Real growth*	*Share*		*Real growth*
from	*to*	*1990*	*2005*		*1990*	*2005*		*1990*	*2005*	
China	ASEAN4[a]	5	13	3 038	3	9	3 145	4	11	861
	NIEs3[b]	88	64	789	94	69	581	75	60	218
	Japan	7	24	3 817	4	22	5 586	21	29	444
	East Asia	100	100	1 122	100	100	829	100	100	294
ASEAN4	China	0	13	33 332	1	16	16 530	4	15	1 133
	ASEAN4	8	18	1 743	9	19	1 560	8	19	640
	NIEs3	69	49	461	68	38	368	39	39	223
	Japan	24	21	589	22	27	906	49	28	83
	East Asia	100	100	688	100	100	730	100	100	224
NIES3	China	32	54	1 457	30	43	566	30	50	622
	ASEAN4	28	20	544	26	23	318	25	22	276
	NIEs3	21	17	641	25	18	240	18	15	284
	Japan	19	9	325	19	16	315	27	12	99
	East Asia	100	100	812	100	100	373	100	100	335
Japan	China	5	34	2 230	8	32	482	9	34	868
	ASEAN4	35	26	141	33	21	-6	32	23	78
	NIEs3	60	40	121	59	47	20	59	43	81
	East Asia	100	100	229	100	100	48	100	100	150
East Asia	East Asia	100	100	541	100	100	323	100	100	251

Source: M. Ando and F. Kimura, "Fragmentation in East Asia: Further Evidence" (January 2007), p. 32.

Abbreviations: ASEAN, Association of Southeast Asian Nations; NIEs, newly industrialized economies.

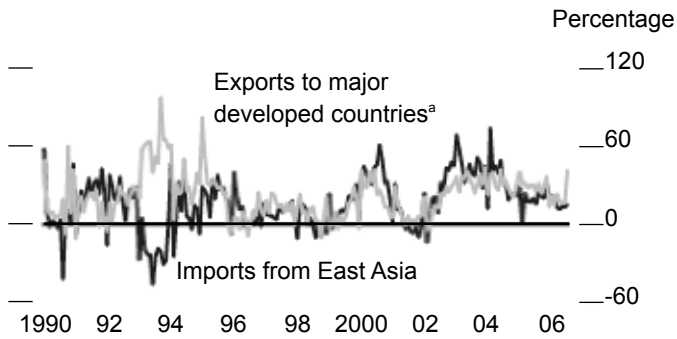
[a] Refers to Indonesia, Malaysia, Philippines and Thailand.

[b] Refers to Republic of Korea, Singapore and Taiwan Province of China.

China plays a central role in global triangular trade and related regional integration. It imports intermediate products, mostly from other East Asian economies, and assembles and then exports final goods to global markets (figure 4). To date, the domestic value added in China to manufactured exports has been a relatively modest share, estimated as averaging around 20 per cent,[24] though it is expected to rise over time. As a result, China runs a trade deficit with East Asia and a surplus with the United States. This reflects complementarity between the globally oriented assembly industries in China, and the country's East Asian suppliers of parts and intermediate products. Labels on many of China's manufactured exports should read as "Made in East Asia", in order to reflect more accurately their true origins and the related regional production integration process.

There are indications of increasing sophistication in the domestic manufacturing industry of China and a corresponding slowing of imported components, but the extent and implications of this trend are not yet clear.[25] This dynamic is also an indication of China as both an opportunity and a challenge to the economies of the region. While China has been an opportunity for potentially competitive Asia-Pacific SMEs in some industries, both in terms of the integration of regional production and its expanding domestic market, the country has also presented an important competitive challenge, particularly in labour intensive industries. The "China challenge", particularly in terms of pricing, has forced enterprises in the region to improve their productivity and performance, or to establish a China presence. As China begins to "move up the value chain", so will the China challenge. However, there are also indications that emerging constraints in the Chinese economy in areas such as labour as well as product and process quality are providing new opportunities for competitive enterprises in the Asia-Pacific region at both the "higher end" of the value chain and in traditional labour-intensive activities.[26]

Figure 4. Correlation between growth in exports from China to major developed countries and imports from East Asia to China



Source: Asian Development Bank, *Asian Development Outlook 2007* (Manila, 2007).

[a] European Union, Japan and the United States of America.

[24] See, for example, Lau and others (2006) and Koopman, Wang and Shang-jin (2008).
[25] See, for example, Li Cui and Syed (2007).
[26] See, for example, Gaulier, Lemoine and Ünal-Kesenci (2005) and Athukorala (2007).

MNEs from outside the region, such as Apple, Cisco Systems, Dell, Hewlett-Packard Co. and Levi Strauss & Co., have been key participants (direct/indirect) in and beneficiaries of the regional production integration process. For example, MNEs accounted for close to 60 per cent of total exports from China in 2005, thus playing a central role in connecting East Asia's increasingly integrated production system to global markets (ADB 2007). These MNEs, along with Asia-based large enterprises such as Acer, Lenovo, Li & Fung and Hon Hai Precision Industry, are using local SMEs as key suppliers. This is particularly pronounced in industries such as electronics/ICT, apparel/garments, autos/auto parts, and agro-industry. Therefore regional production integration, driven by the globalization of production, is providing expanding opportunities for Asian suppliers at all levels to access international markets. (For a discussion of regional enterprise and production integration, see Ando and Kimura 2007 and ADB 2007).

2.4. Implications for the prospects of Asia-Pacific SMEs

The globalization of production and the related production integration in (East) Asia have important implications for the growth prospects and competitive performance of Asia-Pacific SMEs. On the one hand, by facilitating linkages with foreign buyers and large MNEs—from within and outside the region—the forces of globalization loosen the constraints of domestic economies and markets, and provide local SMEs potential access to globally distributed assets, including information, technology, skills, capital and markets. On the other hand, globalization also brings about more intense competition in home markets from imports, new foreign investors, and expanding large domestic enterprises.

The globalization of production seems to affect SMEs in three ways, according to studies by the Organization for Economic Cooperation and Development (OECD) of SME adjustment to globalization in 18 OECD and 8 East Asian countries (OECD 2007 and 1997, see also Goh 2007):[27]

- For a relatively small group that already have near internationally competitive capabilities (estimated by OECD at around 5 to 10 per cent of SMEs in the sample countries), globalization opens new opportunities to access international markets through linkages with foreign buyers, or as suppliers to MNEs;
- For a larger group (estimated by OECD at 25 to 50 per cent of SMEs), globalization poses challenges at home. SMEs that are potentially competitive in terms of the capability to meet international standards are likely to be forced into export-oriented production (as suppliers to MNEs, for example) or will have to upgrade their capabilities to remain competitive at in the domestic market. Lagging SMEs in this group will not remain viable without significant upgrading in products, production processes and management capabilities;
- For the remaining SMEs (about 40 per cent of the total) that are in traditional activities, particularly small-scale services, with relatively simple technology serving small, local markets, the pressures of the globalization of production are less immediate and urgent; they may be relatively insulated from the opportunities and threats of globalization. However, although less urgent, the

[27] As Wignaraja (2003) notes, there are no comprehensive cross-country studies of this type available on the effects of globalization on SMEs in developing countries, and very few such studies on individual countries, including in Asia and the Pacific.

competitive pressures are not necessarily absent for such firms. For example, the entry of global retailers such as Carrefour, Tesco and, increasingly, Wal-Mart into domestic markets in Asia and the Pacific is changing fundamentally the local competitive environment of small, locally oriented producers and retailers, as reflected in the case of Thailand. These enterprises are then forced to find a viable competitive strategy in this radically new environment, or face going out of business. It is not clear how far or how deep the winds of global change will sweep the traditional SMEs of the region.

The proportion of SMEs in the above three categories will vary depending on the level of development of specific economies in the Asia-Pacific region and the capabilities of their respective SMEs. In the more developed economies of East and South-East Asia that have a generally good base of SMEs with the potential to become internationally competitive, the pattern of adjustment can be expected to be similar to the above, for example in terms of the proportion of SMEs in the first two categories. The less developed and lagging economies of South-East Asia (such as Cambodia, Lao People's Democratic Republic, Myanmar and Viet Nam), Central Asia, South Asia and the Pacific are likely to have a smaller proportion of such SMEs that can take advantage of the new product market opportunities offered by the globalization of production. Therefore they are likely to have a correspondingly larger group of SMEs at risk from the increased competition resulting from globalization that requires significant upgrading, as well as a larger group of SMEs that may be relatively insulated from the effects globalization.

This leads to the central question: What factors are likely to increase the prospect of Asia-Pacific SMEs participating in the globalization of production in a way that leads to sustained income growth? That is, how can Asia-Pacific enterprises in the first and second categories identified by the OECD study—particularly the second—transcend the constraints of weak productivity and confinement to local markets? And what are the corresponding implications for government and public policy, and for international donors? Before considering these questions, it is important to examine not only the opportunities, but also the risks of the participation of Asia-Pacific SMEs in global production systems.

2.4.1. Potential risks and constraints for Asia-Pacific SME suppliers

To be a supplier to or an affiliate of an MNE can be a significant challenge for a local SME. To qualify as a subcontractor, a local supplier generally has to meet tough business standards and make potentially large up front investments to get its production process and products ready. Significant retooling of a company's assets and workforce is generally required, and in order to do this, some cash-flow commitments are inevitable.

Up-front investments can be highly specific to the product requirements of the MNE and, as such, could be financially risky for the investing firm if subsequent purchase orders or contracts are not forthcoming. The specificity of upfront investment may place the local SME supplier in a "lock-in" position to a particular international buyer, and therefore potentially in a significantly disadvantaged negotiating position. The higher the specificity or the more specialized the investment, the greater the scope for the MNE buyer to renegotiate the contract for a better deal. Multiple sourcing opportunities of the MNE can further exacerbate this lock-in problem as the MNE can easily turn to alternative local suppliers who have also invested in specialized assets upfront and may be ready and willing to fulfil supply contracts at more competitive terms.

In comparison with larger domestic suppliers, local SMEs, as noted, may not have: (a) the requisite cash-flows and/or the access to financing for the needed upfront investment; (b) the availability of a skilled, educated and trained workforce; or (c) the negotiating proficiency of larger suppliers when dealing with MNEs. Furthermore, larger domestic enterprises with significant scale economies may be able to offer lower prices than SMEs for the same quality, reliability and standards. Such economies would exist where the product to be supplied is standardized and more generic. Advantages of scale economies are less likely where products involved are more idiosyncratic and the size of delivery more limited.

To obtain a supply license or contract, firms must adhere to a new set of rules or codes of conduct—the global standards noted earlier. As recent examples in the toy and food industries have shown, significant attention is being placed on the traceability and the social and ethical provision of inputs and services. As noted, MNE-designated and potential suppliers must comply with a wider range of new and more restrictive standards. It is likely to be relatively more costly for smaller firms to put in place the required capabilities and receive "the good housekeeping seal of approval" from international buyers. Larger suppliers may be able to better manage this large fixed cost of doing business with MNEs as they can better realize scale economies.

While improving the capacity to meet global standards and the corresponding upgrading of the delivery codes of SME suppliers could result in a pool of more competitive global suppliers in the longer run, a more immediate effect of this additional challenge to supplying MNEs is that it could cause a skewing of supply opportunities against SMEs. Ultimately, the ability to become a designated supplier and participant in the MNE global value chain depends on the capacity of indigenous SMEs to overcome the constraints of smallness and newness.

At the same time, there are now indications that the offshoring activities of United States, European and even Japanese multinationals may be scaled back. Soaring oil prices, currency depreciation and rising wages are some of the reasons why multinational executives are rethinking their offshore activities. According to a recent analysis (Goel, Moussavi and Srivatsan 2008, 1) of a recent *McKinsey Quarterly* study:

> The production of high-tech goods has moved steadily from the United States to Asia over the last decade. The reason is familiar: lower wages, a stable global economy, and rapidly growing local markets. These factors combined to make nations such as China and Malaysia favored manufacturing locations. In the last two years, however, the favorable economic winds that carried offshoring forward have turned turbulent. The new conditions are undermining some of the factors that made manufacturers of every stripe, including those in high-tech, move production offshore.

The *McKinsey Quarterly* (2008) conducted a series of interviews with senior executives of international firms on their global supply chain strategies. When asked to identify factors that contribute most to the setting of their global supply chain strategy, executives interviewed indicated that supply chain risk is rising sharply, and pointed to the greater complexity of products and services as the key influencing factor. Global supply

chain managers are now facing new complexity challenges and more turbulent economic conditions, which make cross-border sourcing more problematic. MNEs need to balance the benefits that offshoring can offer against the growing risk of more complicated offshoring transactions. The possible scaling back of the offshoring of multinationals could have a significant impact on the prospects for Asia-Pacific SME suppliers. As multinationals rethink their outsourcing strategies and contemplate scaling back, it is even more important that local SMEs become more relevant to multinationals, and be able to offer the kind of cost-saving and efficiency benefits that make offshoring economical. Domestic SMEs will need to offer clear advantages that create value for multinationals in order for them to be included in the production networks of MNEs.

2.4.2. Implications of the globalization of production for SMEs: summing up

The emergence of global value chains and production networks has a number of important policy-related implications for the competitive performance of enterprises, in addition to the general competitiveness factors discussed above:

- *Understanding value chains.* Global value chains and related production networks require a basic change in mindset by public and private decision makers. Competitive performance is shaped to a significant extent by activities and relationships outside individual enterprises, and relates to linkages within particular value chains. Therefore the traditional focus on strengthening enterprise-level productivity is not sufficient for improving the competitive performance of firms within a GVC framework. It also requires improving value-chain related linkages, or "network efficiencies", and the related policy, institutional and business environments. For example, a focus on GVC-related interfirm logistics is required, particularly as related to SMEs, as is a focus on improving import/export procedures for particular value chain-related products;

- *Opportunities—and risks—for new entrants, particularly SMEs.* As noted, the organization of production within the framework of global value chains and networks allows specialization by small enterprises based on a single function or a few functions and/or parts and components. It also enables a focus on regional and even global niche markets. However, given the risks of lock-in, a key challenge for SMEs is to find ways to upgrade over time (for example through product and process innovation)[28] within value chains in order to gain pricing power and flexibility and to add value;

- *Opportunities for value creation.* In the context of GVCs, enterprise core capabilities in a given industry's value chain are the key to competitive performance; less important is the choice of industry or sector—there are few truly "sunset/sunrise industries". From the perspective of enterprises, particularly SMEs with their particular constraints, creating value is not restricted to possessing global brands or participating in high-technology industries. It is possible to create value and to be a competitive supplier anywhere along an industry value chain through specialization and upgrading. In one vivid example, suppliers of key personal computer components have higher profit margins than global brands such as Dell and Acer;

[28] For a discussion of various options for upgrading, see Abonyi (2007).

- *New paths to innovation.* Global value chains provide a framework for creating globally innovated products, which allow the combination of activities and technologies from diverse sources without having such capabilities in house. A dramatic example is the iPod, where Apple came up with the original concept for the product and combined the components all from outside suppliers around the world.[29] It means that even a small firm with an innovative idea can leverage the resources of other firms (including other SMEs) to develop the concept and bring it to market;

- *Match the best—or outsource to the best.* International buyers and MNEs in global value chains have options to source globally. Therefore, SME suppliers have to be able to match the performance of the best in their class in order to become and remain suppliers within the framework of GVCs. As stressed earlier, this requires not only efficiencies in production activities, but also the capability to meet a variety of stringent global standards. Meeting some standards will also require network efficiencies beyond the boundaries of the firm. For example, delivering products on time, as is essential within the GVC framework of integrating parts and components, is dependent on inter-firm logistics systems, and efficiencies in import/export procedures;

- *New types of financing needs.* As noted, it is likely that SMEs aiming to become suppliers in GVCs will have to fund significant investments, for example, in new technology and skills. Given the general constraints on SME financing, this is an important constraint for small firms. Furthermore, participation in production networks has new financing implications, with potential risks for SMEs. For example, there has been a noticeable shift from the use of letters of credit, which allow bank financing of SME working capital needs to unsecured, open-account trade finance; this shift places significant burdens and risks on smaller suppliers lower in the production network.[30] However, there is increasing awareness that pushing costs and risks down the supply chain to smaller firms can risk the competitive performance of the network as a whole;[31]

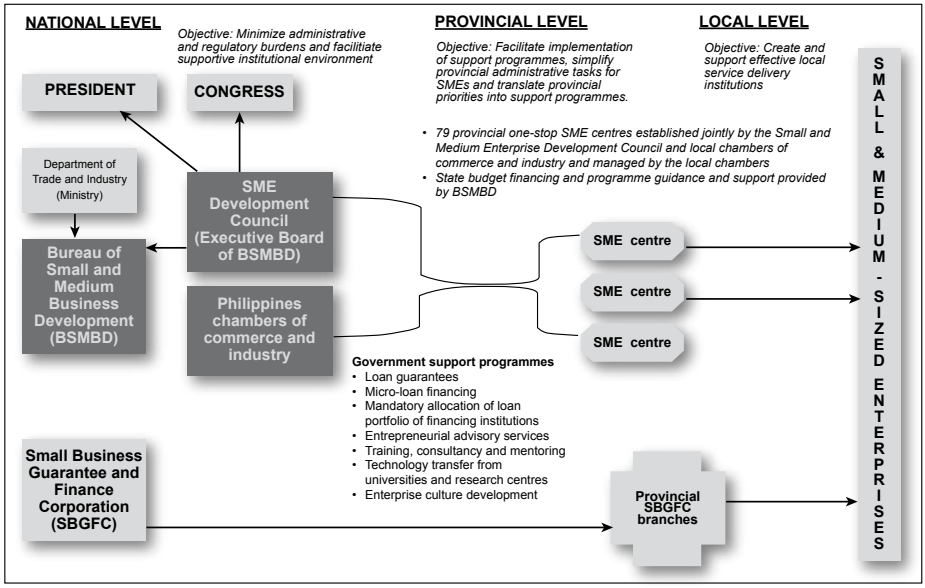
- *Competition among networks—not only enterprises*. As noted, competition within the framework of global value chains occurs, to a large extent, among networks of firms. For example, in the automotive industry it is not just Toyota that competes with Ford, but Toyota and its supplier network that competes with Ford and its supplier network; similarly, it is Nike and its suppliers that compete against Reebok and Adidas and their respective suppliers. It is in this context that competitiveness is a function of inter-firm or network efficiency, and not only individual enterprise productivity and performance. The network is only as competitive as its weakest link—and its weakest (inter-firm) linkages.

The underlying trend of the globalization of production is changing the basic prospects for the competitiveness of Asia-Pacific SMEs on international and domestic product markets. For SMEs that are in traditional activities, and that use relatively simple technology, operate with low levels of skills and serve relatively stable and small, localized markets, the opportunities and threats of globalization may be less urgent and pronounced. For those SMEs that are already at near-internationally competitive capabilities and

[29] See Linden, Kraemer and Dedrick (2007).
[30] See, for example, Aron (2007).
[31] See, for example, Global Business Intelligence (2007).

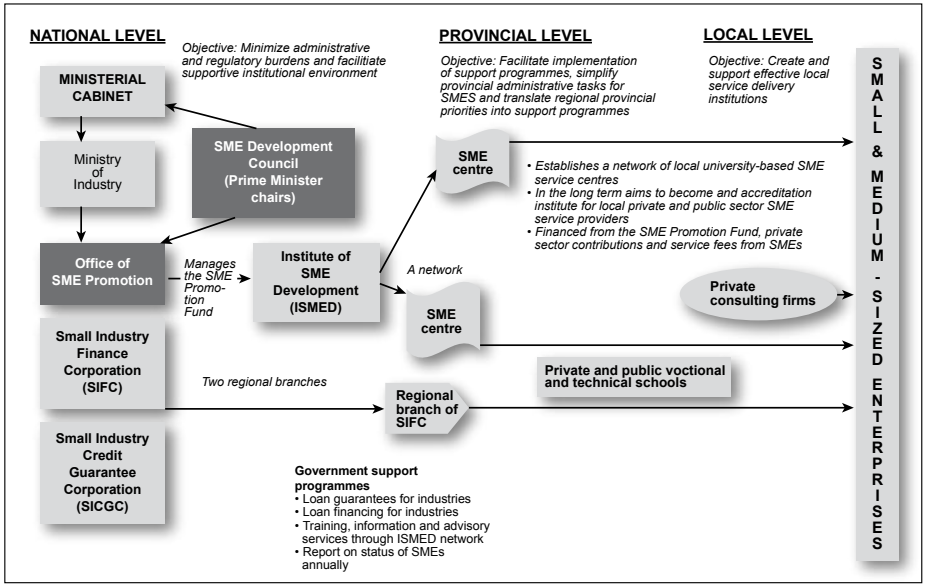
are active in export-related markets, the challenges of globalization pose both new opportunities and threats, as they must adjust their capabilities and performance to remain internationally competitive in an increasingly complex and demanding environment. Perhaps facing the biggest challenge—and opportunity—is a middle group of Asia-Pacific SMEs, at present active primarily in their home markets but that have the potential to be competitive on a larger scale. The globalization of production is likely to force these small firms to change in order to remain viable, either because of pressures to undertake export-oriented production (for example as suppliers to MNEs), or to face new foreign competitive entrants into their home markets. Either way, the competitive prospects of these SMEs will hinge on their abilities to upgrade their performance—in production process, products, and management capabilities—to meet international standards. Although competitiveness is fundamentally an enterprise-level concept, this poses new challenges collectively to enterprises, governments and donors. The importance of this issue is increasingly recognized by the countries of the region, as reflected in the comprehensive institutional frameworks to support SMEs in the Philippines and Thailand (figures 5 and 6).

Figure 5. Institutional support for the development of small and medium-sized enterprises: the Philippines



Source: Organization for Economic Cooperation and Development, "Promoting SMEs for development", background document for the Second OECD Conference of Ministers Responsible for Small and Medium-Sized Enterprises (SMEs) on Promoting Entrepreneurship and Innovative SMEs in a Global Economy: Towards a More Responsible and Inclusive Globalisation, Istanbul, 3-5 June 2004, annex 1, figure 6.

Figure 6. Institutional support for the development of small and medium-sized enterprises: Thailand



Source: Organization for Economic Cooperation and Development, "Promoting SMEs for development", background document for the Second OECD Conference of Ministers Responsible for Small and Medium-Sized Enterprises (SMEs) on Promoting Entrepreneurship and Innovative SMEs in a Global Economy: Towards a More Responsible and Inclusive Globalisation,, Istanbul, 3-5 June 2004, annex 1, figure 7.

3

FOREIGN DIRECT INVESTMENT (FDI), GLOBAL SOURCING AND INDUSTRIAL LINKAGES

As discussed in Section 2, the globalization of production is creating potentially important competitive opportunities and challenges for Asia-Pacific SMEs as suppliers and competitors within the framework of global value chains. It is useful to consider this issue within the more general context of trends in FDI and global sourcing, and their implications for industrial linkages involving SMEs.

Over the last two decades, the use of external outsourcing has become an important strategic issue, with increasing recognition of the benefits that effective outsourcing and international production strategies can provide. In the never-ending quest for greater efficiency and cost savings, many companies have decided to source parts and components from low-cost suppliers globally, and in many instances have transferred certain segments of or the entire production process to new locations overseas. Indeed, international procurement and novel offshore integrated production arrangements have become critical to the competitiveness and success of global firms. Many corporations now have established presences across North America, Europe and the Asia-Pacific region, often away from their own corporate headquarters and traditional markets. As a result, FDI and trade have grown in an unprecedented fashion (UNCTAD 2008).

3.1. Motivations for FDI and the development of global value chains

Historically, companies have invested in overseas production facilities to gain access to locally bound natural resources, to be closer to their customers and markets, and to access markets they otherwise would have been precluded from because of high tariff and non-tariff protections. In the academic literature, investment motivated by these types of factors is referred to as “horizontal” FDI. More recently, MNEs from developed countries have been investing overseas in order to take advantage of: (a) cross-border factor cost differences; and (b) an available and abundant pool of technology and skilled personnel. This latter type of foreign investment is referred to in the literature as “vertical” FDI (for discussions on FDI, see Caves 1982; Markusen 1984 and 1995; Helpman 1984; Helpman and Krugman 1985; Brainard 1993; Dunning 1979, 1980, 1981, 1993, 1996 and 1998; and others). Multinational enterprises today are also motivated to establish overseas production facilities and cross-border sourcing for a variety of other reasons, including:

- Reduced inventory costs through just-in-time delivery of parts and components;
- More efficient utilization of capacity and core capabilities;
- Access to specialized skills and resources that the company could not develop organically or acquire through mergers and acquisitions;
- Benefits from special tax privileges and economic investment incentives of the host country;
- Benefits from special tariff treatments available between the host country and key trading partners.

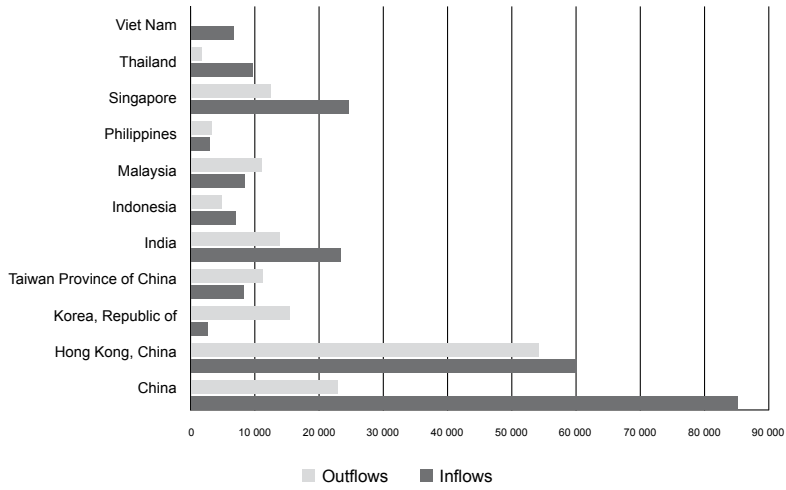
3.2. Trends in foreign direct investment

Developing countries are attracting more foreign investment than ever before. According to the United Nations Conference on Trade and Development (UNCTAD 2008), FDI inflows have rocketed from $316.4 billion in 2005 to nearly $500 billion in 2007. Among developing economies, those in Asia and the Pacific were the largest recipients of foreign investment. In 2007, the region received about 64 per cent of the overall investment to developing countries. By way of comparison, the 2007 figure is slightly lower than the 2005 figure of 67 per cent, representing a slight shift in foreign direct investment to developing economies in other regions.

Within the Asia-Pacific region, China attracted the most FDI with about $84 billion of investment in 2007, followed by Hong Kong, China with $60 billion, Singapore with $24 billion, and India with $23 billion. China; Hong Kong, China; Singapore; and India together represented 59 per cent of the total FDI to Asia and the Pacific. This proportion is relatively unchanged from the 61 per cent figure of 2005. In terms of growth in FDI, the most remarkable increase was registered by India, with an impressive 200 per cent increase between the years 2005 and 2007. In 2007, a record-high level of investment poured into India. While still the fourth-largest destination economy in Asia, behind China; Hong Kong, China; and Singapore, India has rapidly caught up with Singapore and outstripped other South and South-East Asian countries in 2007 (figures 7 and 8).

Figure 7. Flows of foreign direct investment in select economies of Asia and the Pacific, 2007

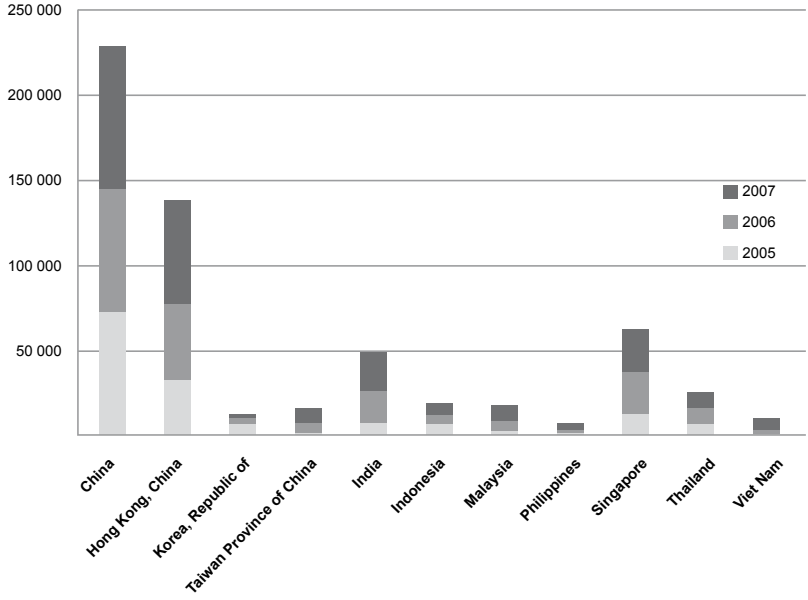
(Millions of United States dollars)



Source: United Nations Conference on Trade and Development, *World Investment Report 2008* (United Nations publication, Sales No. E.08.II.D.23).

Figure 8. Inflows of foreign direct investment for select developing economies of Asia and the Pacific, 2005-2007

(Millions of United States dollars)



Source: United Nations Conference on Trade and Development, *World Investment Report 2008* (United Nations publication, Sales No. E.08.II.D.23).

As reported by UNCTAD, OECD countries remain the major sources of investment worldwide. Of the record-high outward investment of nearly $2 trillion, developed economies accounted for 85 per cent of the total value, or about $1.7 trillion. The United States remains the biggest financier, followed by other European members of OECD. While the overall investment environment in developing regions is expected to remain positive, the onset of financial crises in the United States and in other developed countries is expected to slow down foreign investment in the coming years.

3.3. FDI and spillover benefits

International sourcing and contract production for multinational firms have significant economic implications for domestic suppliers and the host countries. Multinationals, with their vast capital and technological resources, can assume an important role in the economic development of the host countries. An enormous amount of theoretical and empirical research has been done on the economic impact of multinationals and FDI. While generally the effect of FDI on growth has been viewed as positive—FDI raising the welfare level of the recipient country—there are circumstances where FDI could lead to an immiserizing growth (Brecher and Diaz-Alejandro 1977 and Anam and Bhanich Supapol 1992, among others). It has been shown theoretically that foreign investment

could lead to a perverse outcome, whereby the welfare level of the recipient country is negatively affected. Such an adverse effect occurs when FDI is combined with distorting economic conditions in the host country, such as non-productive rent-seeking activities, taxes, minimum wages and quotas, and inappropriate technology transfers.

Empirically, the effects of foreign firms on the domestic economy and the extent of spillover benefits have also been extensively studied in the economic and business literature. The results of extant studies, however, have not been definitive. At both industry and firm levels, researchers have found a significant improvement in the local producers' productivity as a result of foreign direct investment and participation (Blomstrom and Kokko 1998; Kathuria 2001; Lipsey 2002; Buckley, Clegg and Wang 2002; Görg and Greenway 2004; Alfaro and Rodríguez-Clare 2004; Wei and Liu 2006; Dreffield and Love 2007; and Haskel, Pereira and Slaughter 2007). This correlation is believed to be related to the transfer of technology and management know-how from multinational parents to their foreign affiliates (subsidiaries, local joint venture partners and local contract manufacturers), and possible spillovers of such knowledge and technology to domestic firms. On the other hand, Haddad and Harrison (1993), Aitken and Harrison (1999), and Chung, Mitchell and Yeung (2003) have found a negative or no correlation between FDI and local firm productivity. To some extent, the contradictory findings can be explained by the methodologies employed and the nature of the data used in the analysis.

Notwithstanding the inconclusive nature of the empirical evidence on the benefit and cost of MNEs, there is now a widespread belief among policymakers that foreign investment and MNEs generate positive economic externalities or spillover benefits for host countries (Meyer 2004). As such, in recent decades, Governments of developed and developing countries have competed fiercely for foreign investment and have introduced numerous laws and policies which favour multinational firms.

It would appear that there is now a shared sentiment among policymakers that multinationals play an important and positive role in a country's development strategy. Appropriate policies and incentives should be provided to multinational firms to encourage local-affiliate production, local sourcing of parts and components, and transfer of technology to local manufacturers so that maximum spillover benefits can be realized. It is therefore pertinent to systematically identify mechanisms and channels by which spillovers from MNEs are generated and absorbed by local firms. The conventional view is that local manufacturers can benefit from doing business with multinational firms directly and indirectly. Local contract manufacturers, parts and component suppliers, local distributors and back-office service providers may all benefit from new business opportunities and enlarged markets, and thereby economies of scale and scope, when they contract with an MNE. In many cases, they may also receive technologies and market knowledge from the contracting MNE firm, either through foreign parent-affiliate transfers or through technology licenses. Other local firms may also benefit indirectly through what is often referred to as the demonstration effect, as well as through increased competition and the transfer of skilled employees. These concepts are not new and can be traced back to the earlier work of Caves (1974), Mansfield and Romeo (1980), and others. Arguably, the existence and size of spillover benefits would be determined by the activities of the MNEs in the host country, the specific nature of the relationship between foreign MNEs and their local affiliates and contractors, the institutional factors of the host country, and the skills and technological absorptive capacity of the participating local firms.

3.4. Global sourcing and the development of industrial linkages

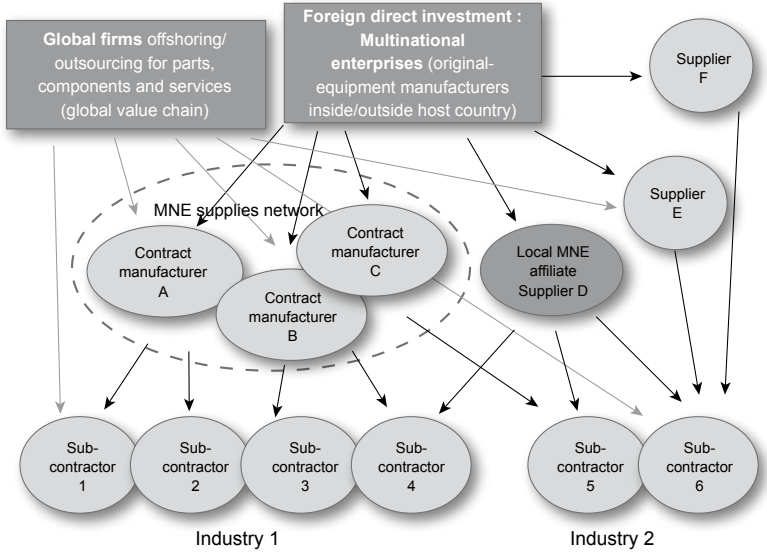
To many people, the term offshoring is often used interchangeably with the term outsourcing. However, according to the OECD *Glossary of Statistical Terms* (see http://stats.oecd.org/glossary/index.htm), "outsourcing means acquiring services from an outside (unaffiliated) company or an offshore supplier. In contrast, a company can source offshore services from either an unaffiliated foreign company (offshore outsourcing) or by investing in a foreign affiliate (offshore in-house sourcing)". Global outsourcing is basically the sourcing of goods or services, required by corporations to fulfil certain segments of their value chain activities, from vendors, suppliers or contractors located in different countries throughout the world. These suppliers could be affiliated or unaffiliated suppliers and the context of buyer-supplier relationships could range from simple once-and-for-all purchase orders to continuous contracts for goods and services or longer-term subcontracting arrangements. Affiliated offshore suppliers could be wholly owned subsidiaries, equity joint venture partners, or contractual joint venture partners. Unaffiliated offshore suppliers could be totally independent contract manufacturers or suppliers loosely connected through strategic alliances or license arrangements. The decision to contract with outside unaffiliated suppliers for goods and services is often referred to as the decision to "contract out" or to "vertically disintegrate." The categorization of the various forms of outsourcing and buyer-supplier relationships has been extensively discussed in the economics and organization literature (Masten 1984; Monteverde and Teece 1982; and Williamson 1975, 1979, 1985 and 1992).

Outsourcing today is considered to be central to a firm's strategic management, and outsourcing activities now involve much more than a tactic for reducing costs of back-office functions such as accounting and ICT. Notwithstanding the fact that contracting out mundane back-office activities is still a big business, suppliers and consultants are now targeting much more strategically significant functions, such as manufacturing, logistics, product design and other innovation-related activities of multinational firms. Clearly, what is being outsourced, the way global sourcing is structured, and the specifics of the relationship between buyers and suppliers can all have impacts on the development of local suppliers, the overall supplier network and, ultimately, the deepening of the development and economic growth of local industries.

Typically, multinational firms secure the inputs and services required for their operations from either suppliers within their established international supplier network (with affiliated or unaffiliated companies) or from independent suppliers overseas. The measurement of the size of outsourcing worldwide by global firms is problematic, given the wide array of definitions and forms of "international outsourcing". Nonetheless, it may be worthwhile to look at a commonly used measure—the share of manufacturing imports accounted for by intermediate goods, parts and components—as a rough proxy for the extent of international outsourcing. According to one study (Molnar, Pain and Taglioni 2007), outsourcing by firms in OECD countries has increased steadily over the period 1992-2004, and there was a sharp increase in the amount of parts and components (as a share of total manufacturing imports) imported from China and the ASEAN countries (see figure 9).

Indigenous suppliers, both upstream and downstream, benefit directly and indirectly from outsourcing contracts; through the development of industrial backward and forward linkages, the host country becomes more productive and internationally competitive (Lim and Pang 1982; Lall 1978, 1980; and Alfaro and others 2006).

Figure 9. Global supply networks, global value chains and backward linkages



Source: A. Bhanich Supapol, "Linkage effects, technology transfer, and the development of small and medium enterprises in the electrical and electronics industries in Thailand", in A. Bhanich Supapol, ed., *Transnational Corporations and Backward Linkages in Asian Electronics Industries* (New York, United Nations, 1995).

Abbreviation: MNE, multinational enterprise.

At the firm level, local subcontractors can benefit from supplying intermediate inputs to foreign manufacturing clients in a variety of ways, including:

- Greater rate of technology diffusion—the adoption of new products and processes introduced by foreign multinational clients, improved access to new production methods, management know-how and technology from buyers and other suppliers;
- Upgrading of local skills through training and intra-industry transfer of talented workers;
- Increased demand for existing products and services leading to greater capacity utilization, employment and investment in new facilities, research and development operations, and new businesses with higher value-added (economies of scale and scope);
- Access to new product designs, international quality standards and international market information;
- Increased market competition leading to greater efficiency among local suppliers.

There are ample empirical cases where contracts between foreign producers and domestic suppliers have resulted in significant positive economic spillovers for the suppliers (Lall 1978; Bhanich Supapol 1995; Xu 2000; Buckley, Wang and Clegg 2002; Alfaro and Rodríguez-Clare 2004; Javorcik 2004; Meyer 2004). Additionally, it is now well recognized that spillover benefits could be realized by suppliers within the same industry as the multinational manufacturers (intra-industry or vertical spillovers), as well as by suppliers in related but different industries (inter-industry spillovers).

While it is conventionally accepted that local suppliers can indeed benefit from contracting with multinational firms, what is not as clear is where and under what circumstances benefits are expected to be greatest. Extant studies on backward and forward linkages have convincingly argued that a country's capacity to take advantage of FDI externalities may be limited by its absorptive capability—the technological and managerial capabilities of local contractors and local conditions— including the educational level of the country, infrastructure, legal systems and financing (Lall 1980; Blomstrom 1986; Bhanich Supapol 1995; Kokko, Tansini and Zejan 1996; Blomstrom and Kokko 1998; and Buckley, Clegg and Wang 2002). By and large, the literature argues that FDI and global sourcing externalities are determined to a large extent by the type of products or services being sourced, how offshoring activities are being structured, the preparedness and technical absorptive capacity of local contractors, as well as by the willingness of multinationals to engage in the training of local suppliers and transfer proprietary technology and management know-how.

Earlier studies (Davidson and McFetridge 1983; Masten, Meehan and Snyder 1991; Bhanich Supapol 1995) argued that the characteristics of: (a) the home and host countries; (b) the multinational firm; (c) the supply contractor; and (d) the product being produced together determine how offshoring activities will be structured (that is, using either an arm's length procurement contract or long-term subcontracting with a related firm, or producing internally through a wholly owned subsidiary). Relying on a well developed area of economic theory—the economics of transaction costs—it could be argued that products involving more technologically advanced components, more complexity, and output quality that is more difficult to assess would more likely be sourced from an affiliate or a wholly owned subsidiary rather than an outside contractor, everything else remaining the same. The implication is that multinationals would choose to outsource from a related party (where the supplier is either fully owned, or closely affiliated within a global supply network) for products that are higher valued, more complex and more difficult to transact. In terms of global value chains, it can be surmised that inputs and activities positioned closer to the higher value-added and possibly more technologically complex end of the production chain will likely be sourced internally or reserved for long-term trusted, reliable and proven suppliers within the established supply chain. New or unproven domestic suppliers may be precluded from participating in the MNE network altogether, or may be restricted to supplying only basic products involving older or antiquated technologies—activities with relatively little scope for spillover benefits.

From the perspective of multinational firms, one of the main considerations in the globalization of manufacturing and sourcing is how it may affect the locational configuration of the home bases for their various strategic businesses, and how this configuration may impact their future production arrangements, technological interdependency and,

ultimately, future ability to compete internationally. Globalization is likely to lead to a geographical dispersion of value-added activities. These activities necessarily involve the reallocation of resources, technology and management knowledge between firms and their subsidiaries, affiliated suppliers and independent arm's-length local suppliers. In many respects, multinational firms must weigh the benefits of outsourcing and contract manufacturing against the risk of transferring assets, some of which may be strategic and core to the firm, over to related or independent overseas contract manufacturers. Internationally contracting for production, parts and components could result in the emergence of new players, representing potentially new competitors for multinational incumbents. In an earlier article published in the *Harvard Management Update,* Martha Craumer stated:

> In some cases, companies leave themselves vulnerable to a market coup by former partners when they outsource. Such was the case with the German consumer electronics company Blaupunkt … To beef up the product line it offers to its dealers, Blaupunkt decided to add VCRs and contracted the work out to Panasonic (once a lowly circuit-board stuffer). Later, with the Blaupunkt reputation attached to its products, Panasonic approached the dealers directly and presto, it had a ready-made distribution network for its own product line. (Craumer 2002)

As cited in the article, according to Ed Frey, a vice president at Booz Allen Hamilton, "In effect, all Blaupunkt did was give access to its dealer network to Panasonic". The implication here is that MNEs must decide carefully what segments of their global value chain ought to be outsourced and what activities should be done in-house. In theory, companies should be concentrating on unloading their non-core activities by using third-party service providers, and focusing on delivering their core activities well in order to boost productivity and returns. In practice, however, deciding what is core and non-core is complicated, and what is considered non-core today may become strategically pertinent tomorrow. The use of contract manufacturers has allowed original equipment manufacturers to cut costs and free up productive resources, but as Arruñada and Vázquez (2006) cautioned, it could also unleash new and dangerous competitors:

> As IBM and other companies have learned, however, contract manufacturing is a two-edged sword. For one thing, a CM [contract manufacturer] is privy to an OEM's [original equipment manufacturer's] intellectual property (IP), which it can leak to other clients or arrogate. For another, an ambitious, upstart CM can claim for itself the very advantage it provides an OEM. Having manufactured an OEM's product in its entirety, the CM may decide to build its own brand and forge its own relationships with retailers and distributors—including those of the OEM. When these things happen, the OEM may find itself facing not only more dangerous incumbents but also a competitor of a new kind: the once under-estimated CM.

According to the authors, smart contracting out means keeping the hazards of potential traitorous contractors under control.

Also important to the supplier, in addition to the direct economic benefit of being selected to deliver goods and services to a multinational firm and being a part of the production network of the MNE, is the potential for spillover benefits that can boost competitiveness and growth, and subsequently increase its shares of the market. In order

for a supplier to capture beneficial spillovers from its dealings with multinational firms, it first must be selected and included in the network of qualified suppliers. Multinational firms and the affiliated contract producers (tier 1 suppliers) of original equipment manufacturers normally would search for qualified contractors locally, and select firms that can deliver the best bundle in terms of quality, reliability and price. Once selected, the supplier may then rely on subcontractors locally or internationally and, in turn, would select the next tier of subcontractors based on their ability to deliver on quality and price. Local suppliers can benefit from their interactions with foreign buyers, and whether they benefit more or less is thought to be a function of their own resource endowment (technological capacity, human resource and capital resource), their entrepreneurial tendencies, and industrial clusters and networks (Meyer 2004).

Local firms, large and small, compete for the business of multinationals. Market transactions and competition normally sort out who the suppliers in the network will be, and what the relative shares of the economic rent from the supply transactions will be. Do smaller and medium-sized firms face more constraints in accessing and linking into MNE supplier networks? That is, do multinational firms prefer to deal with larger and perhaps more established firms when selecting subcontractors? Are smaller firms more disadvantaged when negotiating a supply contract with MNEs? Do larger firms benefit more from the outsourcing activities of multinationals, and are they more equipped or better prepared to internalize the external benefits that may exist? If there are economies of scale and scope, larger firms may indeed have a distinctive advantage for participating in the GVCs of foreign multinationals. A policy question for the host country is whether small and medium-sized business should be supported so that they can better participate in the GVC activities, and if so, what should be the nature of such policy support?

3.5. Global supply networks: challenges and constraints for SME suppliers

Whether achieved by subcontracting for parts and components using occasional purchase orders, or by engaging local suppliers on a longer-term contractual basis within or outside of their global supply networks, the establishment of backward and forward linkages and the deepening of industrial development as a result of the procurement process of multinationals are generally viewed by policymakers and business practitioners as important and integral parts of the economic development and growth. As in most developing nations, economies in the Asia-Pacific region are dominated by small and medium-sized manufacturers, with the exception of several countries where there are explicit policy biases in favour of large firms and conglomerates (Bhanich Supapol 1995). Small companies are affected by and, in turn, affect globalization.

Small companies play a vital role in contributing to their national economies through employment, entrepreneurship, job creation, new product and process development, and exporting. Small local businesses face competing products from overseas and, at the same time, create new challenges for other companies overseas. With globalization, an increasing number of entrepreneurs and small business enterprises are being approached by potential offshore customers, largely as a result of intensified export promotion efforts and initiatives by governments, the large and ever-increasing number of trade shows and practitioners' conferences and, above all, the rapidly growing reliance on e-commerce and

web-based Internet marketing. While the economic importance of SMEs and the economic contributions of foreign multinationals are well recognized, a relatively scarce amount of empirical research has been done directly on the relationship between multinationals and the development of domestic SMEs.

Multinational enterprises have been strategically sourcing from China, India and other emerging Asian-Pacific countries for years. However, new international sourcing arrangements are no longer restricted to the traditional lower-technology oriented industries (for example, automotive and electronic parts and components), with transactions for simple and low value-added activities. Such arrangements are now also found in technology intensive industries (pharmaceuticals, semi-conductors and aerospace, among others) involving more complex and specialized transactions.

Landing a contract to sell its products to a multinational firm or an MNE affiliate can be a significant challenge for a small or medium-sized local company in Asia and the Pacific. To qualify as a subcontractor and participate in the MNE global supply network, a local supplier often has to meet tough business standards and make a huge upfront investment to get their products ready. Significant re-tooling of a company's assets and workforce is generally required and, in order to do this, some cash-flow commitments are inevitable. Issues regarding constraints to becoming a supplier for an MNE in a changing, more dynamic and more demanding environment were discussed in section 2.4.1. Domestic tier 2 or tier 3 suppliers typically face the challenge of large upfront investments that are, in many cases, highly specific and serve specialized uses. Given the required commitment and risk, SME suppliers may choose to forego or may be unable to economically finance the investment, and thereby, are precluded from participating in an international supplier network of multinational firms. As argued above, this may be more of an issue for SMEs than for larger and more established suppliers.

Ultimately, the ability to become a designated supplier and participant in the global value chain of an MNE depends on the capacity of the indigenous SME to overcome the liabilities of smallness and newness. Getting supply contracts from MNEs means that local SMEs can: (a) expand their product lines and service more markets; (b) hire more people and make investments in training and educating their workforce; (c) acquire new machinery and equipment; (d) upgrade management skills and expertise; and (e) grow. Additionally, MNE supply contracts can also provide SMEs with greater access to funding from financial institutions, which is vital and necessary for growth.

Dealing with MNEs through their supply networks or subcontracting arrangements can build industrial linkages for the home economy and can result in expanded production, employment and improved competitiveness. The impact of outsourcing can be significant where indigenous suppliers could also benefit "indirectly" (in terms of things that they did not explicitly contract for) from their buyer-supplier relationship.

One aspect of outsourcing that is deemed to be highly beneficial to the suppliers is the transfer of technology and management know-how from the buyers and their affiliates. These types of spillover benefits have been well discussed and documented in the technology transfer literature. While the extant literature has highlighted the existence of such benefits through case studies and productivity analyses, more information is yet required on where and how they may in fact arise. Conventional wisdom would suggest

that the ability to capitalize on these external benefits depends heavily on the technological absorptive capacity of the supplying firm. What is pertinent on this score therefore, is whether the absorptive capacity of SMEs is greater or less than that of larger firms. Moreover, larger firms may be able to exploit technological spillovers better because of more diversified businesses, economies of scale, and perhaps experience. Serendipitous technologies may be more likely to be used because of the greater number of possible applications associated with a more widely diversified business. More capable scientists, engineers and workers may be more attracted to larger firms because of job security, profile and/or better pay. On the other hand, it is conceivable that small and medium-sized companies may be more flexible, nimble and agile, and thus can better and more quickly absorb spillover innovations or technological improvements. It may be argued that SMEs are more entrepreneurial and innovative and do not suffer from the bureaucratic inertia (X-inefficiencies) typically associated with larger firms.

The motivation to transfer technology may also be different when dealing with SMEs as opposed to larger local suppliers. MNEs may underestimate SMEs, not viewing them as future rivals, and are therefore more likely to offer to transfer some of their technologies and know-how. Larger local supply firms can be more threatening to MNEs and represent a much more daunting potential rival down the road. For example, the Chinese computer manufacturer Lenovo, once a contract manufacturer to IBM, bought up the personal computer business of IBM for around $1.75 billion in 2005. This was a landmark deal and the transaction highlighted the new consequences of the globalization of production, where business is no longer unidirectional but expands also from emerging to developed economies. Consequently, MNE buyers may pre-emptively seek to protect their technologies more carefully and restrict spillovers or unintended technology flow.

3.6. Multinational enterprises and host country Governments

In a highly competitive global environment, being able to rely on local suppliers for commodities, parts and components is critical to the survival and success of multinational companies. As such, a multinational enterprise must seek out, engage and retain reliable, qualified (technically and managerially) and cost-competitive local suppliers for its global supply network. At the same time, host country Governments compete fiercely for the potential business of multinational enterprises, and actively promote FDI through a number of initiatives (Bhanich Supapol 1995; Ostry 1998). While direct support from Government in terms of tax incentives, minimized administrative burden and other investment incentives can help promote FDI, arguably the crucial element for attracting multinational enterprises is still the availability of skilled and qualified local subcontractors (Bhanich Supapol 1995).

In light of the changing nature of the offshoring activities of MNEs towards more specialized and higher value-added transactions, increasingly skilled subcontractors will be required; failure to keep up with international standards would result in a loss of FDI and opportunities to benefit from MNE procurement contracts. If local SMEs fail to upgrade and meet the technological and sustainability challenges of the new outsourcing environment, they will likely be passed over by MNEs. Being precluded from international value chain activities is costly to the host economy directly in terms of the foregone foreign exchange and economic value of the supply contracts, but perhaps more significant is

the foregone economic value from indirect spinoffs and technological transfers that could have been realized. If a country no longer offered MNEs outsourcing cost advantages or market opportunities, MNE buyers would likely find alternative manufacturing platforms where they could produce and operate more competitively, and would turn to different subcontractors for parts and components. The reversal of international integrated production trends can be very difficult and costly for the country, and it is pertinent that local small and medium-sized firms are appropriately encouraged to move up along the technological ladder and proactively upgrade their technological competencies so that they are better poised to participate in the evolving global value chain.

Arguably, SMEs face more constraints technologically. Larger parts and component supply firms have more resources that they can allocate to various inventive activities and are perhaps in a better position to exploit the results of their research and development because of economies of scale and scope. They may also have better access to foreign technology because of their possible greater involvement in international markets and exposure to technologies available elsewhere. In some countries, larger firms receive more support from the government. They have often been favoured to receive research and development subsidies and funding from the government because of: (a) their prior track records and performance (early-mover advantages); (b) availability of in-house scientist and engineers; (c) developed expertise that cannot be found elsewhere; or (d) their established relationships with the government funding agencies. Moreover, larger firms may be more experienced in dealing with MNEs and more familiar with technology licensing practices. They can rely on in-house legal resources when contracting for technology—resources that are likely absent amongst smaller or medium-sized business establishments. It has been argued that larger firms face lower funding costs. Possibly because of their available pool of assets that can be used as collateral, specific investments in both tangible and intangible assets, and an available corporate (financial and operational) information system which makes monitoring less costly, larger firms have greater access to different types of financial products and funding institutions.

Entrepreneurial and smaller businesses typically find it difficult to finance longer term investments, such as in research and development, which have uncertain payoffs and longer return periods. Significantly disadvantaged by the liabilities of newness and smallness, entrepreneurs and SMEs may find it increasingly difficult to participate in the international supply chain of MNEs. This notwithstanding, some of the entrepreneurial and smaller research firms have been particularly successful as providers of scientific and technical inputs to large manufacturing MNEs both offshore and onshore. A case in point is the vast number of bioengineering firms that have played a vital role in the development of new blockbuster drugs for large international pharmaceutical companies. Indian research firms have participated in outsourced clinical trials and drug development for North American and European pharmaceutical giants in recent years. It would appear however, that such offshore research firms are specialized and technologically more advanced, and can deliver added value for MNEs. Another example comes from the ICT industry, where small programme developers overseas have been involved in supplying application-specific and specialized programming services to mega-ICT and systems firms from developed countries, and have undeniably been pivotal to the latter's commercial success.

Anecdotal evidence would suggest that small and medium-sized enterprises, regardless of their size, could successfully plug into the global supple network of an MNE. At the same time, it is important to note that there are indications of a slowing of the outsourcing of MNEs in a changing international environment. This has to be monitored carefully by both firm-level and government decision makers in terms of the competitive options of firms and implications for the role of government (see section 2).

The questions of whether government support for SMEs is warranted, to what extent, and what form such support should take are indeed central to the host country's industrial development strategists and policymakers. Policy initiatives to allocate appropriate resources to small and medium-sized suppliers could include providing supplemental resources for upgrading and improving the manpower of SMEs, and for the adoption and diffusion of new technologies and management techniques. Ideally, industrial policies should be designed to encourage the transfer of technology to local suppliers, and for MNEs to establish offshore manufacturing facilities in areas where employment effects and industrial linkage benefits are expected to be most beneficial. This should stimulate and pump-prime the creation of sustainable and balanced industrial developmental and growth for the economies of Asia and the Pacific.

4

POLICY RECOMMENDATIONS

4.1. Introduction

This final section reviews the requirements for increasing the competitiveness prospects of Asia-Pacific SMEs within the context of the challenges of the globalization of production, and seeks to provide some specific recommendations on how SME development in the region could be taken in new and potentially fruitful directions. These recommendations seek to address the core question running through this research paper, namely: what can usefully be done to increase the competitive performance of Asia-Pacific SMEs?

As introduced earlier, competitiveness is fundamentally an enterprise-level concept, referring to the relative performance of firms in particular product markets. Nonetheless, the competitive performance of enterprises is shaped by a country's: (a) endowment; (b) macroeconomic conditions, including a country's policy and institutional environment; and (c) microeconomic factors, including the quality of a country's business environment, the relative sophistication of a firm's operations, and the state of enterprise cluster development in a particular economy. Given the challenges of current trends in the globalization of production, attention must be focused on the requirements of enterprise linkages and network efficiencies, and on upgrading options (for example, product and process innovation) as key dimensions of the competitiveness of Asia-Pacific SMEs.

Within this context, it is possible to identify a range of activities that can contribute to strengthening the prospects for the competitiveness of SMEs. As noted, Asia-Pacific economies vary greatly in terms of their characteristics and levels of development. In general, there are three types of economies in terms of SME support requirements: (a) economies with significant and widespread deficiencies in basic infrastructure, and constraining policy, institutional and regulatory environments; (b) economies with less severe or urgent deficiencies in the "basics" (for example, relatively good infrastructure, and adequate policy and regulatory frameworks) but some relatively weak key institutions; and (c) economies that have good basics for production activities (manufacturing and/or services) and a relatively efficient SME support structure, but that require further strengthening of particular policies, institutions and support services. Therefore each country has to pick the appropriate mix of policies, programmes and institution-building initiatives to be undertaken by the government and private sector, and supported by international development partners.

4.2. A role for government

The case for government intervention to assist SMEs is anchored in the assumption that significant market failures prevent domestic small enterprises from building the capabilities necessary to participate in global value chains. These are assumed to arise because of weaknesses or disadvantages that SMEs are perceived to have relative to large firms—and their peers in other countries—in accessing key resources and services

such as finance, information, technology and international buyers. Therefore, specific policies, programmes and institutional frameworks are seen as needed to assist SMEs in overcoming market failures. In this context, a public policy or publicly financed programme to support SMEs must be anchored in a sound economic rationale.

While such a programme is necessary, alone it is not sufficient for an appropriate public policy or publicly financed SME support programme. Special-purpose policies and programmes, particularly if they involve subsidies in some form (for example, transfers from general taxpayers to special targeted interests, such as SMEs), carry the risk of creating economic distortions, for example with regard to business incentives. Therefore, it must also be demonstrated that such initiatives are likely to lead to net welfare benefits for society as a whole. From this perspective, examples of market failures cited as causing a bias against SMEs and requiring a public response include the following:

- Asymmetric information on SMEs, (available to formal financial institutions, for example) and distortions in credit markets (such as in the operations of the banking system) restrict SME access to financing;
- Relatively higher costs of training and technology development, along with the inability to appropriate the full benefits of such investments, cause underinvestment by SMEs in training and in technology acquisition and development;
- Smallness creates relative cost disadvantages for SMEs to an important extent because small enterprises have a significantly weaker voice than larger firms, in terms of influencing policy and public expenditure decisions, because of, among other things, constraints on their participation in public-private institutions and dialogue. As a consequence, policies and regulations often impose disproportionately high fixed costs on small firms;
- Small size limits capacity-building options, for example restricting relative access to costly support services (consulting, financial, legal, training, among others) and information, limiting SME productivity and therefore competitiveness.

The above are all fairly generic and perennial adversities encountered by SMEs in virtually all economies, both developed and developing.

An effective public policy and programming framework for Asia-Pacific SMEs should begin with an understanding of constraints and possible solutions—as perceived by SMEs themselves. A useful way of identifying such constraints is by giving a voice to SMEs in appropriate forums for dialogue with government. This, in turn, requires recognition by governments of the need for effective channels of communication with small enterprises, not only the large firms that are the usual participants in national chambers of commerce and federations of industry in the Asia-Pacific region. This can be pursued in a number of ways, including outreach to SME associations and other business associations that have a large SME membership. At the same time, it has to be informed dialogue. In a recent study that surveyed SMEs about their perceived needs, OECD reported that enterprises indicated a lack of government support for facilitating their participation in global value chains. However, the study then went on to suggest that SMEs responded in this way because they had "…limited understanding of the global environment and

therefore cannot easily identify policy initiatives facilitating their effective participation in global value chains" (OECD 2007, 6), for example, existing and readily available SME skill upgrading programmes.

A generally supportive macroeconomic environment for enterprise development includes low budget deficits, appropriate inflation management, competitive real exchange rates, and an outward-oriented trade regime. The macroeconomic environment needs to be particularly stable and predictable from the perspective of small firms, as fundamental unexpected policy changes may threaten the viability of SMEs more readily than that of larger firms (which have a larger resource cushion). The experience of Asia-Pacific economies with financial liberalization and exchange rate adjustments provides suggestive examples.

Furthermore, it may be necessary to put in place economic and financial safety nets for SMEs to prevent the large-scale macroeconomic and financial disruptions experienced during the Asian Crisis; this is increasingly important in the context of the present global financial crisis and its expected impact on Asia-Pacific exports.[32] Beyond macroeconomics, a clear, fair and stable legal and general regulatory framework is also essential, providing SMEs with the assurance that government will not discriminate against small firms in the interpretation, implementation or enforcement of laws and regulations, and that it will provide a framework for fair competition with respect to, among other things, commercial transactions, intellectual and commercial property rights, the tax code and labour legislation.

It is also important that FDI promotion policies and programmes facilitate the integration of domestic SMEs into global value chains, consistent with an economy's comparative advantage. An important dimension here includes initiatives to attract new types of MNEs that may not be household names, but that play a pivotal role in managing global production integration in specific value chains of particular relevance to a given economy, such as Flextronics in the electronics and ICT space. In this context, it is essential to ensure that import/export regulations and procedures are efficient and consistent with global value chain-related requirements of the strategies and operations of such global suppliers. Estonia and Ireland are examples of countries that are taking effective GVC-related approaches to FDI that could be instructive to Asia-Pacific economies.

4.3. Improving the micro-environment for SME competitiveness

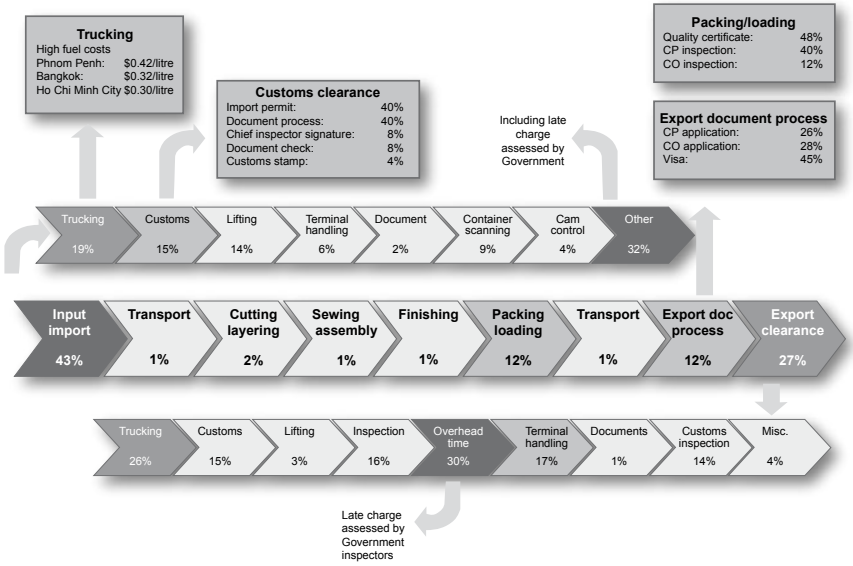
4.3.1. Quality of the business environment

Creating a business-friendly environment for SMEs is a critical requirement for enhancing the general competitiveness prospects for small firms. This includes: (a) ensuring the relative ease of entry and exit of new firms (see section 1 for a discussion of this issue); (b) simplifying import-export policies and procedures, particularly from the perspective of small firms and in the case of small economies; (c) streamlining bureaucratic rules and procedures that hinder the expansion and export potential of SMEs; (d) assessing the costs and benefits of specific regulations that could place a disproportionate burden on small enterprises; and (e) implementing regulations with

[32] At the time of writing, Viet Nam seemed poised to allocate a proportion of its $1 billion stimulus package to a new SME credit guarantee fund—a somewhat controversial move.

attention to the flexibility needed by SMEs. Focusing on trade facilitation issues, such as streamlining and improving customs procedures and regulations, is particularly important in the context of providing SMEs with access to participation in global value chains. The application of value chain analysis to identify constraints in import/export procedures is illustrated in figure 10 in the context of Cambodian garment exports (denim jeans), which are especially reliant on the import of parts and components.

Figure 10. Value chain analysis of denim jeans exports from Cambodia: implications of import-export procedures



Source: World Bank, *Towards a Private Sector-Led Growth Strategy for Cambodia,* prepared by Global Development Solutions LLC (Washington D.C., 2003), Chart 10, p. 71.

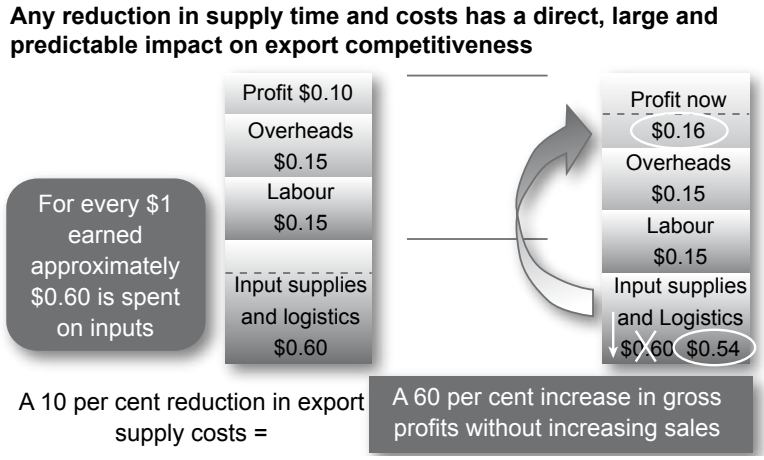
Abbreviations: CO, Certificate of Origin; CP, Certificate of Performance.

Competition within the framework of global value chains hinges on the efficiency of logistics systems that link geographically distributed producers and buyers. Some Asia-Pacific economies, out of necessity, need to concentrate at this stage on building critical basic infrastructure, such as airports, highways, ports and telecommunications/ICT systems. However, it is essential to begin to focus simultaneously on the less visible requirements of improving the flow of goods through an economy, including across borders. This includes addressing issues related to the institutional, legal and regulatory environment of transport services such as, among others: (a) consistency with international rules to ensure transparency and predictability; (b) efficiency of multi-modal transport linkages; (c) containerization; (d) load and warehousing centres; (e) hub and

feeder networks; (f) e-communications and e-commerce; and (g) a linking of logistics services to improvements in trade facilitation procedures (such as customs rules and procedures). This requires a "logistics perspective" from the outset, particularly one that explicitly recognizes the particular constraints and needs of SMEs.

For example, small enterprises require reliable access to externally provided logistics services that seamlessly link production with distribution and that can handle the distinctive needs of small-batch producers, including special purpose systems such as refrigerated trucks and pre-cooled storage facilities for fresh fruit and vegetables. An example of such a logistics perspective as the basis of public policy and public-private partnership, including a focus on the particular needs of SMEs, is provided by South Africa (see, for example, CSIR 2005). The impact of even marginal improvements in logistics and trade facilitation services on profits and competitiveness is illustrated in figure 11.

Figure 11. Improvement in logistics + trade facilitation = competitiveness and profits



Source: Ian Sayers, *Trade Facilitation in Export Delivery Supply Chains* (Geneva, International Trade Centre, 2003).

Financing is generally cited by Asia-Pacific SMEs as a critical factor determining viability and growth. As noted, commercial banks and investors have been reluctant to finance SMEs in the region, or when they do provide funds they charge a significant premium. This is due to factors associated with small firms, such as high perceived risk, higher transaction costs (per amount lent), incomplete accounting records, inadequate financial statements, and weak business plans. These general problems of SME financing in the region have received considerable attention (see, for example, Beck 2007 and Ferranti and Ody 2007). The general financing constraint is particularly important in the context of the participation of Asia-Pacific SMEs in global value chains. As discussed, such participation often requires substantial investments in developing appropriate production technologies, logistics services, skills, capacity expansion and certification to meet a variety of stringent global standards. Working capital requirements can be especially

challenging for small suppliers in GVC-oriented production networks. Suppliers in GVCs may not receive payment from their (often bigger) customers until weeks or even months after the delivery of orders. With the shift from letters of credit, which allow bank financing of the working capital needs of SMEs, to the increasing use of unsecured open account finance, SME suppliers face additional financing constraints and risks. Payment delays and, in the event of further complications, contract enforcement and collection of late payments, can be particularly significant challenges for a small firm.

Therefore a key requirement is for financing mechanisms that can help small suppliers overcome liquidity constraints, for example through the increased use of creative financing services such as equipment leasing, factoring (the purchase of a firm's accounts receivables), and securitization of SME loans, as in the case of Bangladesh, the Republic of Korea and Singapore. Wider use may also be made of guarantees from multilateral development banks, for example to enhance credit ratings of securitized SME loans in Asia-Pacific economies. Additional measures could include providing legal assistance to suppliers negotiating contracts, providing legal protection against unfair (payment) practices, and shortening payment delays for local SME suppliers through legislation or fiscal incentives. An exploratory initiative to establish business-angel networks in one or more Asia-Pacific countries might also have merit, possibly working in conjunction with established business associations.

In other areas of SME development, identifying ways of addressing the gender imbalance between SME owners is one field that probably has not received as much attention as it might (beyond basic gender mainstreaming), at least in those countries where the asymmetry is most apparent. Similarly, in some countries where this is pertinent, there has perhaps been insufficient attention paid to the paucity of robust SMEs in areas belonging to minority ethnic groups and/or remote or economically depressed areas, where this is seen to be a problem. Subregional and country-specific initiatives in areas such as eco-tourism and handicrafts—such as "stay another day" interventions—may have utility in this regard.

Cultural and social issues relating to risk-taking in business, and the stigma of business failure, also tend to get limited coverage beyond the academic community of researchers, as does the promotion of an entrepreneurial culture in a country. Initiatives designed to identify and then support the entrepreneurial framework conditions of Asia-Pacific countries would be worthy of pursuit. Possibly a good starting point would be to support the inclusion of more Asia-Pacific economies in the Global Entrepreneurship Monitor exercise. An alternative would be to design a regional equivalent, intended to serve as an evidence-based diagnostic platform on which to pursue some specific interventions, on a national or subregional basis.

As yet, there has been relatively little attempt to take the creative economy approach to SME development in Asia-Pacific developing countries. In 2008, UNDP and UNCTAD (2008) co-published the *Creative Economy Report 2008,* which seeks to explain the thinking behind the (still evolving) creative economy approach.[33] As the report

[33] Definitions of the creative economy tend to differ, although a good point of reference might be a context in which: "… the interface among creativity, culture, economics and technology, as expressed in the ability to create and circulate intellectual capital, has the potential to generate income, jobs and export earnings while at the same time promoting social inclusion, cultural diversity and human development" (UNDP and UNCTAD 2008, iii).

intimates, the creative economy concept is particularly pertinent—and enticing —for cities or regions (as opposed to whole countries) that already host resource wealth in terms of the creative arts, education, culture and history. Some of the issues raised in the report are highly pertinent to SME development, and would merit some exploratory research work in the Asia-Pacific region, perhaps focusing on some cities that have a strong cultural legacy, but that, with the possible exception of tourism (which is a critical ingredient in the creative-economy mix), have arguably underperformed economically. Cities such as Luang Prabang and Hue, in the Lao People's Democratic Republic and Viet Nam respectively, immediately come to mind.

Indeed, the whole issue of business innovation (and entrepreneurship), and how to promote it, usually does not feature prominently in more conventional SME development initiatives in developing countries—particularly in those that are least developed. (One notable exception is Bhutan and its "Tenth Plan" (Bhutan 2009), which seeks to support SME development in part through the promotion of greater business innovation and creativity, focusing in particular on niche products.) SME development programmes are often focused most on poverty alleviation and making household enterprises more sustainable and formalized. While of undoubted merit, such interventions may not add significantly to a country's overall economic competitiveness and long-term growth trajectory. Initiatives that seek to acknowledge and reward innovation and creativity among SMEs and entrepreneurs, either at the regional or national levels, could be a useful catalyst in promoting productivity within domestic business communities.

Furthermore, innovation and creativity in business is virtually impossible to achieve if adequate intellectual property rights protection (both regulations and their effective enforcement) is not in place. And yet the issue of intellectual property rights is not often given prominence within many SME development programmes, possibly because of the perception that it is something most keenly pursued by multinational enterprises, to the detriment of local SMEs. Regional and national initiatives aimed at raising awareness of intellectual property rights could be of merit for SME sector development, and could improve the wider enabling environment for business as a whole.

Another area that receives relatively less attention is that of SME exits, including bankruptcy. The notion of technical assistance that assists in the orderly closing of small firms, and the efficient recycling of assets, may not appeal to policymakers and development partners that do not wish to be seen as "corporate undertakers". But the issue is an important one, as discussed earlier. If financiers are to lend to SMEs, and entrepreneurs are to take the professional (and socio-cultural) risk of starting up new business ventures, then there needs to be a transparent and efficient means by which less competitive SMEs can close down, and more competitive SMEs can then enter that space. There is also scope for more work in helping developing countries to create markets for SMEs, so that new market entrants and/or investors have the option to acquire existing companies, rather than establish wholly new ventures. Sadly, this may be an increasingly vexing issue in the next few years, as the global economic downturn takes its toll on numerous Asia-Pacific SMEs.

4.3.2. Sophistication of enterprise operations and strategy

Business development services.[34] Governments and donors in Asia and the Pacific have focused on providing business development services (BDS) for SMEs to help overcome perceived market imperfections. BDS refers to all types of SME support services, including: (a) training in business-related skills; (b) counselling and consulting; (c) technology development and transfer, involving the adaptation, design and development of appropriate technologies; (d) information on markets, buyers and technology; (e) business linkages, including between SMEs and large firms (subcontracting, for example) and among SMEs (such as the development of enterprise clusters); and (f) financing. As discussed in Abonyi (2007), the "market development paradigm" is now the most widely used organizing framework for the provision of BDS. It involves creating a market for a diverse array of services, with government and donors playing the role of facilitators for privately provided BDS. The basic assumption is that BDS can be best provided not directly by governments and donors, but by well-developed markets for such services on a commercial basis, even for the lowest income segments of the SME sector. The experience with this approach to BDS has been mixed to date.[35]

The rest of this section touches briefly on selected business development services of particular relevance for strengthening the prospects of participation of Asia-Pacific SMEs in global value chains.

Understanding global value chains. SMEs traditionally serve local markets. Therefore they generally have a limited understanding of the opportunities global value chains could provide for small enterprises, and of the corresponding structure, dynamics and requirements of subcontracting to foreign buyers within the framework of GVCs. Given the limited resources and restricted managerial capabilities of small firms, it is generally both difficult and expensive for SMEs on their own to obtain such information. Increasing the competitiveness-related sophistication of Asia-Pacific SMEs then has to begin with familiarization with the potential benefits and operational requirements of engaging with international buyers in the context of particular global value chains.

Standards and certification. Access to global markets through GVCs depends increasingly on meeting a range of stringent standards, confirmed through a credible certification of: (a) inputs (sourcing of wood for furniture, for example); (b) products (such as safety and health standards); and (c) production processes (such as labour standards). International buyers generally look to source from certified companies as an indication that the minimum required capabilities are present. Where testing and inspection is not carried out by the GVC buyer, suppliers must be able to prove the reliability of their inspection procedures, test data and conformity with international standards. The costs of certification and compliance with an increasing number and variety of standards may be relatively high for SMEs. But meeting such standards provides potential access to international markets, and strengthens the general competitiveness of SMEs by improving their production-related capabilities. Governments (and development partners) can support the availability of certification systems, and help ensure that they do not impose a prohibitive burden on small enterprises. SPRING Singapore, a government agency for fostering a competitive

[34] This section is based on Abonyi (2007).

[35] See Abonyi (2007) for a more detailed discussion of business development services, particularly from the perspective of SME participation in global value chains.

SME sector, is a good example of this; among other things, it publishes a highly informative (50-page) guide for SMEs: Make Standards Work for You. Similar guides for SMEs in other Asia-Pacific countries would undoubtedly be of use. Furthermore, the use of clusters (see below) can provide a mechanism for group certification for small enterprises, increasing the likelihood of a sufficient "supply" of certification services, and reducing their cost.

Government procurement. In many Asia-Pacific countries, State agencies are a major source of revenues for companies, but SMEs often struggle to qualify as suppliers to State-run procurement departments, for a host of reasons. This excludes them from a potentially large client base. Governments, and SME development agencies in particular, could do much to make their procurement policies more transparent and inform the SME community about the criteria necessary to become an approved supplier. Here again, SPRING Singapore is a good example, providing SMEs with a user-friendly guide on government procurement, published in conjunction with the Ministry of Finance. (Not only is such an initiative useful for SMEs, it also obliges State agencies to streamline their procurement policies, from which various efficiency and cost gains can be derived.) Governments can also review their procurement policies to ensure that they do not needlessly discriminate against SMEs.[36]

Technology upgrading. If they are to improve their competitiveness prospects in the context of global value chains, SMEs need to upgrade their technological capabilities and sophistication in areas such as production layouts, productivity improvements, raw material testing, quality standards and management, metrology, information systems and other technical services. Supporting measures could include: (a) providing financing to enable SMES to obtain technical certification; (b) establishing productivity centres specifically for SMEs; (c) setting up technology-related training services; (d) promoting partnerships between SMEs and technical institutes; and (e) supporting public technology institutions in developing special services aimed at small enterprises.

Of particular importance to SMEs is the adoption of modern ICT technologies that are essential for participation in global value chains, and that can also enhance the general competitive performance of small firms by reducing their costs and time, and by extending their reach and coverage. In particular, ICT can: (a) improve management efficiency by strengthening the organizational capability to process large amounts of data at a relatively small cost; (b) allow small firms to access key information and analysis that has traditionally been available to larger firms, on, among other things, markets, customers and competitors; (c) strengthen the operational efficiency of small firms, through, among other things, more efficient inventory management, ordering, and scheduling; (d) enable SMEs to provide effective after-sale services and support to maintain customer contact and loyalty; (e) increase the capabilities of SMEs for in-house product and process innovation; and (f) leverage existing capabilities and capacity of individual small firms to reduce the advantage of the scale economies of larger enterprises, for example by opening options for new partnerships and linkages.

[36] With the current global economic downturn prompting many governments to increase their spending through stimulus packages and the like, in a Keynesian strategy to support their domestic economies, SMEs would be well advised to make efforts to become acquainted with government procurement procedures.

Skills development and training. Participation in global value chains is likely to require a generally higher level of threshold skills from SMEs. Therefore policies and programmes aimed at raising technical and managerial skills can increase the prospects of SMEs to be competitive suppliers in global value chains. This may be supported by training schemes, information campaigns to educate SMEs about the benefits of increased training and skill development, tax breaks for training, and special-purpose courses in local training institutions. An example of a comprehensive training programme aimed at upgrading SME skills is provided by SPRING Singapore, which, among other things, is the national standards and accreditation body aimed at enhancing competitiveness:

> The SME Training for Enhanced Performance and Upgrade (Step-UP) programme is an initiative by SPRING Singapore and the Singapore Workforce Development Agency to address the training needs of small and medium enterprises (SMEs). It aims to identify the training gaps and relevant courses for SMEs, focusing on industry and occupational skills that are immediately applicable to the workplace.
>
> These courses will offer targeted training with defined end results to help SMEs develop new capabilities and raise the overall industry standards. SMEs that send their workers for such training will enjoy enhanced course fee support from the Skills Development Fund.
>
> To kickstart the programme, SPRING Singapore and the Singapore Workforce Development Agency will work with the industry associations supported under the Local Enterprise and Association Development programme (LEAD) to identify industry-relevant courses.[37]

Information "brokerage". Domestic SME suppliers need to understand the requirements of buyers at different levels in specific global value chains. Government agencies can sometimes play an important role in bringing together MNE buyers (such as Danon, Carrefour, Flextronics, Li & Fung) with potential domestic suppliers—or related business associations—in order to help SMEs understand the requirements of becoming a supplier in GVCs. At the same time, as domestic SME suppliers upgrade their capabilities, government can play an important role in providing information to MNEs on supplier capabilities. The Penang Skills Development Centre in Malaysia is example of an institution that plays this kind of a two-way information brokerage role effectively in the electronics/ICT industry; it also provides a related capacity-building role for SMEs.

Corporate social responsibility and the environment. Congruent with growing concern about the environment and climate change (impact, mitigation and adaptation), there has been relatively little research and technical assistance done in the area of sustainable business for the SME sector. For many SMEs themselves, the notion of having to comply with an increasingly burdensome array of regulations pertaining to the environment is, at first glance, not an attractive proposition. Indeed, it threatens to become yet another set of compliance costs, both informal and formal. While such a perception is understandable, it does belie the opportunity for SMEs to leverage a sustainable business model to competitive advantage, in a number of ways. For example, local SMEs with ISO 14000 accreditation are more likely to attain linkages with foreign-invested enterprises. And export-oriented SMEs that are able to pass a spectrum of environmental audits are

[37] See the SPRING Singapore website at www.spring.gov.sg/Content/WebPage.aspx?id=f68177c9-2dca-4ec2-b6a7-d7ce086962e4.

much more likely to: (a) have their products sourced from international buyers; and/or (b) participate in international production networks.

As institutional and retail investors, as well as retail customers, become increasingly attuned to sustainability issues, issues of price competition for SMEs in developing countries will become more diluted, and replaced by the extent to which they comply with various community and environmental standards. For an SME competing globally, this can be a welcome escape route out of a zero-sum game of accelerating price competition and ever-diminishing profit margins, and a means by which to trap more of the value chain through its brand. And yet many SMEs have little knowledge of this trend, or how to adjust to best effect. There is a need for guidance on this topic, ranging from: (a) how to be compliant in terms of current national and international regulations; through to (b) how to proactively embrace community and environmental standards for competitive advantage.

Codes of conduct for corporate social responsibility. Recent difficulties in the toy and food global value chains highlight the problems of supplier compliance to global standards. When suppliers are unable to meet global standards, related to safety or labour for example, the production network as a whole suffers the consequences. It is important to have a regional forum for supporting best-practice monitoring in the Asia-Pacific region within the broader framework of corporate social responsibility. An effective example of how this can strengthen SME competitiveness is the Cambodian experience in the apparel and garment industry, where the International Labour Organization has acted as an informal monitor, in effect certifying Cambodian garment factories as adhering to high labour standards, supported by capacity-building through the Foreign Investment Advisory Service, thereby strengthening the competitive performance of Cambodian enterprises in this sector.[38]

4.3.3. Enterprise clusters[39]

The investment requirements of participation in global value chains and the constraints of size, discussed above, can make it difficult for individual SMEs to be competitive as international suppliers or to upgrade within production networks. However, through focused cooperation, local suppliers can gain collective efficiencies based on scale (input purchases, for example), specialization (such as producing different parts of a given product) and joint action (such as joint marketing). This enhances their "attractiveness" as suppliers by reducing transaction costs for international buyers sourcing from these firms.

Enterprise clusters are, then, groups of enterprises in the same or related value chains who cooperate to compete. The collective efficiencies gained through cluster-based cooperation, for example in complementary areas of specialization and/or pooled production capacity, can help local SMEs as a group enter and/or upgrade in global value chains. For global suppliers such as Li & Fung in garments, or for global retailers such as Carrefour in fresh fruit and vegetables, SME clusters lower the transaction costs of input collection and marketing output. In technologically more complex GVCs (such as for automotive parts, electronics and ICT), clustering allows the collective sharing of investments needed by subcontractors in process and product upgrading, for example,

[38] See for example Sok Siphana (2005) and FIAS (2005).

[39] For a comprehensive discussion of clusters see Abonyi (2007), on which this section is based. See also Andersson and others (2004) and Das (2008).

acquiring and adapting new equipment, that would be beyond the technical or financial capabilities of individual SMEs. Membership in clusters therefore can enhance the productivity, innovation potential, and competitive performance of SMEs, and allow small enterprises to combine the advantages of smallness (flexibility) with the benefits of size (economies of scale and scope). Clustering increases the effective size of the market and reduces the cost of market access for cooperating SMEs. Furthermore, the existence of supplier clusters in particular industries can also provide competitive locational advantages for attracting GVC-related FDI. Operationally, clusters represent a range of partnerships and linkages, as summarized in table 16.

Table 16. Cluster linkages and partnerships

Types	Description
Vertical supplier linkages	Relationship with (global) customers or higher-tier suppliers to provide better services
Horizontal informal links	Contacting other firms for information, assistance, referrals and learning; contacts built up through trust over time
Horizontal formal collaboration	Collaboration among firms for joint activities (for example sourcing and production) supported by formal agreements
Formal associations	Membership clubs, trade associations and networking groups, such as those set up by service providers, and benchmarking
Gaining access to common assets/resources	Government agencies and other support institutions that provide needed services, education and infrastructure

Source: George Abonyi, *Linking Greater Mekong Subregion Enterprises to International Markets: The Role of Global Value Chains, International Production Networks, and Enterprise Clusters* (United Nations publication, Sales No. E.07.II.F.2).

The critical success factor for clusters is the existence of effective institutions, particularly at the industry level, that facilitate the variety of linkages, such as those: (a) among SMEs; (b) with international buyers; and (c) with government agencies and other support organizations. Successful examples of such institutions include the Surgical Instrument Manufacturers Association of Pakistan in Sialkot and the Sialkot Chamber of Commerce and Industry (Pakistan), the Tirupur Exporters' Association (India), and the Penang Skills Development Centre (Malaysia) (see Abonyi 2007 for a discussion of clusters in the context of global value chains).

Landlocked Bhutan, with its considerable transit constraints, is just one country that is embracing the cluster concept as part of its strategy for both SME development and wider economic development. The Government has identified three industrial parks (Dhamdum, Motanga and Jigmeling), and two dry ports (Gelephu and Samdrup Jongkhar) for initial focus as strategic growth centres, with a mandate to catalyse SME development. It is also beginning to examine the potential for business incubators to support new and entrepreneurial SMEs in prospective sectors.

4.3.4. Subregional cooperation

Subregional cooperation that focuses on production integration within the framework of global value chains can make potentially important contributions to strengthening the competitive performance of Asia-Pacific enterprises, particularly SMEs.[40] Such cooperation can support the development of cross-border partnerships among enterprises, strengthening their competitive performance and the investment attractiveness of the respective economies. To date, subregional cooperation programmes such as the Greater Mekong Subregion Economic Cooperation Program and the Central Asia Regional Economic Cooperation Program have focused primarily on strengthening physical connectivity through cross-border infrastructure and related "software", particularly trade facilitation. There may be merit for similar initiatives within the members of the South Asian Association for Regional Cooperation, and across the island economies of the Pacific. For smaller economies where the domestic hinterland is limited, such as Bhutan, the Lao People's Democratic Republic, Nepal and most Pacific island States, such initiatives could have a significant and positive impact on SME development by helping to improve critical export performance.

Various other programmes have also touched on areas such as tourism (including eco-tourism and "stay another day" initiatives), human resource development, and cooperation on public goods such as environment and health (including initiatives by the Greater Mekong Subregion Economic Cooperation Program). This has helped strengthen the competitiveness of enterprises in these subregions by, among other things, improving cross-border transport and trade linkages. The Asian Development Bank, for example, is to commence the Greater Mekong Subregion Sustainable Tourism Development Project, with a goal of "sustainable tourism development that creates livelihood opportunities for the poor". It will be enacted across nine provinces of the Lao People's Democratic Republic and five provinces of central Viet Nam. One of its core outputs will be to make operational "pro-poor, community-based, supply-chain tourism projects", across 33 subprojects.[41] This project may well serve as a model for replication in other subregions.

However, there has been limited focus to date on the integration of subregional production within the framework of global value chains (the key drivers of East Asian economic growth and integration), as a way of strengthening the competitive performance of Asia-Pacific enterprises, particularly SMEs. Focusing on an integration of subregional production that involves cross-border production partnerships, and related areas such as cross-border logistics, standards and certification, and enterprise clusters, is especially important for small enterprises in lagging economies that are not well connected to regional production systems and international markets. Such integration could provide potential building blocks towards integrating SMEs in a subregion into wider international markets. While some work has been conducted in this area, such as the technical

[40] See Abonyi (2007) for a suggested framework for GVC-oriented subregional cooperation in the Greater Mekong Subregion, with particular focus on SMEs.

[41] See www.adb.org/Documents/Profiles/GRNT/38015022.ASP. More specifically, it "includes the development of tourism products and tours designed and operated by local communities in partnership with the private sector, and supply-chain initiatives to link the production of agricultural goods and handicrafts by poor communities to the local, regional, and national tourism economy. … The output aims to increase rural employment and the incomes of the poor by developing new tourism products and services in partnership with the private sector. New opportunities will be developed to produce and sell local handicrafts, food, and other products to tourists."

assistance provided under various SME development programme loans enacted by the Asian Development Bank, it has been done principally on a country-by-country basis, and not on a subregional level.

As touched on in section 3, among the countries of the Asia-Pacific region there is the risk of "beggar thy neighbour" policies aimed at promoting domestic SME suppliers to international buyers and investors. It may be useful to have an effective forum at both the subregional level (the Greater Mekong Subregion, for example) and regional level (such as the ASEAN Free Trade Area) to discuss the options and implications of regional production integration. In particular, such a forum could focus on how to rationalize individual country policies within a broader framework of intraregional specialization—in particular GVCs—in a way that is consistent with the World Trade Organization.

4.3.5. A proposed programme of action

Finally, we conclude this section, and the paper as a whole, with an indicative programme of action for an international agency like ESCAP, based on the analysis and policy recommendations provided above. It is primarily focused on improving the competitiveness of SMEs in the Asia-Pacific region, specifically within the context of increasing globalization of production and the resulting need to participate in global value chains.

As noted previously, SME (and private sector) development tends to be a fairly crowded field of activity for policymakers, State agencies and international development partners of various hues. So this programme of action focuses on areas where we believe there is currently a gap or paucity of useful initiatives, and therefore where some real "additionality" could be achieved. As intimated earlier, there is a tendency for policymakers and development partners to (quite understandably) focus most of their attention on overcoming the hurdles that prevent initial market entry by new SMEs. And there is a definite need for these kinds of initiatives in many Asia-Pacific economies.

However, for some countries at least, diminishing returns from activities are becoming apparent in this field, and there is probably a greater need for initiatives that assist SMEs in upgrading into more robust and sustainable business entities—in becoming medium and large enterprises, in other words. That is arguably an even greater challenge for many SMEs, for a host of reasons. And yet there can be a tendency for policymakers in particular to focus more on headline numbers for new business start-ups and incorporations. But if those headline numbers are derived in large part by SMEs splitting into two or more business ventures, or inflated by the fact that failed companies are not being logged, then they depict a false El Dorado. More importantly, they also miss the point when one considers that in today's international business environment, SMEs need to graduate to a level where they can establish linkages with global value chains and become active members of these GVC communities. Establishing a greater number of SMEs should not be seen as the end, but rather a means to an end: a robust, varied and vibrant corporate community, comprising business entities of many different forms and sizes.

With the above in mind, the indicative programme of action focuses on interventions that might be most fruitful in some of the less developed subregions of Asia and the Pacific, based on useful lessons learned in some of the more developed economies of the region.

It also seeks to be innovative in its approach, albeit based on robust and evidence-based research. That then means the interventions are mostly of an entry-level kind, intended to serve as an initial platform, from which a more long-term programme could be developed and sustained over time.

The programme of action comprises: (a) six components directly pertaining to the globalization of production; and (b) four slightly more generic pro-SME initiatives that we suggest have tended to be overlooked in SME development activity, and that also could have particularly strong impacts during this current global economic slowdown. The 10 components are by no means mutually exclusive; indeed, there is a strong degree of overlap and complementarity between some of them. Nonetheless, we would suggest that each one focuses on an important issue or topic that would be of benefit for SME development efforts in the Asia-Pacific region.

PROPOSED COMPONENTS OF A PROGRAMME OF ACTION

1. A detailed survey and diagnostic analysis of logistics networks (as opposed to physical infrastructure) in select subregions of the Asia-Pacific region, to: (a) identify; (b) gauge the extent of; and (c) propose ways to address weaknesses in these networks that are cumulatively serving to constrain the ability of SMEs to "plug into" and better integrate in global value chains and production networks. The fruits of this empirical research could then be disseminated and discussed in various specialist forums, attended by relevant stakeholders, leading to a set of specific recommendations and actions relating to logistics. Such an intervention might be expected to have the most impact in some of the landlocked and less developed States of mainland Asia, and some of the island economies of the Pacific, likely pursued on a subregional basis.

2. A project designed to support the conceptualization, design and piloting of new enterprise clusters in select (and pertinent) value chains, with the primary aim of forming groups of SMEs in complementary fields of specialization that could then better plug into global value chains. This would probably need to be pursued at a national level, possibly focusing on economies and SME communities identified as being most likely to benefit from such an initiative. But there may also be some potential for subregional initiatives, where existing frameworks, such as the Greater Mekong Subregion Economic Cooperation Program and the Central Asia Regional Economic Cooperation Program, already exist.

3. A project intended to foster and support the development of cross-border partnerships among SMEs at the subregional level, with the aim of strengthening competitive performance. Again, this could build on existing subregional initiatives, such as the Greater Mekong Subregion Economic Cooperation Program and the Central Asia Regional Economic Cooperation Program, which until now have focused more on strengthening physical connectivity. The intervention should also develop subregional forums that could explore ways to rationalize individual country policies (relating to SME and industrial development) within a broader framework of intraregional specialization in relevant global value chains.

4. An intervention aimed at increasing awareness and knowledge among Asia-Pacific SMEs on standards and certification and their increasingly crucial role as "pass keys" to entering global value chains. The project would be aimed directly at SMEs, providing

detailed information and practical guidance on the (sometimes quite daunting) world of standards and certification, ideally in conjunction with relevant business associations, chambers and SME development agencies. Such an intervention is likely to be focused around key and/or prospective business sectors, with seminars, documentation and other materials distributed to SME communities in select subregions. Ideally, it would be useful to get relevant MNEs from pertinent sectors directly involved in this intervention (for example, participating in some of the seminars and printed materials), so that SMEs could see the benefits to be derived; hopefully, such MNE participation would also provide a platform for the establishment of business linkages.

5. Improvement of the framework conditions for entrepreneurship and business innovation. Relatively little has been attempted in seeking to foster and promote entrepreneurial endeavour and business innovation among SMEs and new ventures. There is a need to identify what specific framework conditions are missing in select economies or subregions, possibly using the methodological approach adopted by the Global Entrepreneurship Monitor surveys. This could then lead to a set of specific recommendations on how select economies could pursue enabling environment policies that would encourage a more vigorous and vibrant entrepreneurial community of potentially high-growth SMEs to develop and blossom. Further, more research work needs to be done on the nexus between SME development, innovation and the creative economy, possibly focusing on specific municipalities in Asia that meet the criteria. Such an intervention—on entrepreneurship and business innovation—would have the asset of focusing on some of the more prospective fields of SME endeavour, expected to be likely future elements in global value chains.

6. A research project relating to SME development and sustainable business (including corporate social responsibility), within the context of the globalization of production and global value chains. The project would seek to design a programme by which manufacturing SMEs in select countries or subregions of Asia and the Pacific could pursue more sustainable business practices, both for the direct benefits to be derived, and so as to meet the requirements of MNEs (for example, ISO 14000 accreditation). In turn, this would enable SMEs to better: (a) plug into international production networks; (b) establish linkages with foreign-invested enterprises; and (c) connect with international buyers. The fruits of the research could also extend to a series of guidelines and seminars for SMEs in specific business fields on how they could effectively pursue sustainable business practices (and higher corporate social responsibility standards). Again, it would be desirable to get MNEs directly involved in the project, at various levels, both for the expert inputs they could provide, and with an eye to the project serving as a platform for any subsequent follow-up efforts. The project could focus in particular on economies (or even subnational regions) expected to be impacted most from climate change, such as Viet Nam and islands in the Pacific.

7. Action to support SMEs in better understanding government agency procurement policies, and how they could better position themselves to take advantage of these policies. Relatively little has been done in this area, and conversely, relatively little has been done to encourage government agencies to put in place more transparent procurement policies that do not discriminate against SMEs. Thus, there would be utility in surveying government procurement policies in the economies of the Asia-Pacific region, from which: (a) a set of applied information guidelines could be issued for SMEs

in relevant countries; and (b) a set of detailed recommendations could be provided to individual governments on how they could make their procurement policies more SME-friendly, based on international best practices. With government spending poised to increase markedly in many Asia-Pacific economies, as part of various economic stimulus policies to counter the global slowdown, this could be a particularly timely and effective initiative.

8. Business-angel networks, which can be very useful in bringing both equity capital and expertise to high-growth SMEs, and at an appropriate scale that bridges the gap between bank lending and more conventional private equity financing. With regard to SME finance, little has been done in the Asia-Pacific region to try and establish such networks, which are quite common in Europe. Even when bank lending is abundant, SMEs need to ensure they do not take on too much debt financing, and must balance this with equity capital if they can. Therefore, a pilot project to try and establish one or more subregional or national business-angel networks would merit closer examination, likely working in conjunction with established business associations and/or cluster initiatives.

9. A project to look at how select economies might go about "dovetailing" their approaches towards FDI and SME development more closely, for mutual benefit. As pointed out in section 3 of this paper, there are very real and considerable synergies to be derived between SME sector development and foreign direct investment, most notably through backward linkages. And yet the strategies by which many developing economies in the Asia-Pacific region tend to support SME development are often independent from their FDI attraction strategies. Such an initiative might have the most impact in less developed or developing economies where FDI inflows are relatively strong, but where SME development activity is thought to be less effective, or vice versa.

10. An examination of the regulatory issue of SME closure and bankruptcy (perhaps an apt element on which to finish). The notion of expending energy on this issue, in support of SME sector development, might seem rather counter-intuitive at first glance. However, this is not the case when one considers that all SMEs have a life cycle of sorts. If it is excessively difficult or expensive to close an enterprise down, entrepreneurs may hesitate to set a new company up. Providers of capital (especially debt finance) will also be far more hesitant to provide funding if the mechanics of business bankruptcy—and taking possession of assets pledged as collateral—are unduly burdensome. Ideally, the orderly closure of enterprises needs to be as smooth as that of establishment, but this is rarely the case. Instead, enterprises in many Asia-Pacific developing countries go into a state of suspended animation, thereby sometimes preventing the efficient recycling of business assets. It also makes SME-related policymaking difficult because data on the SME sector is inaccurate, containing as it does many mothballed businesses. The next year or so is likely to see the number of company closures rise markedly, and now would be a good time to enact an initiative that seeks to assist select Asia-Pacific countries in improving the regulatory environment pertaining to SME closure.

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