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ASEAN and Its SMEs – A New Opportunity?

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Ganeshan Wignaraja, Advisor in the Economic Research and Regional Cooperation Department at the Asian Development Bank, explains that “In an era of moderating growth, ASEAN and its SMEs involved in supply chains represent an opportunity for investors and for sustaining growth.”

While many are focused on whether or not ASEAN will become an Economic Community as planned by the end of 2015, the real issue is the untapped opportunities for investors from high performing small and medium enterprises (SMEs) in ASEAN economies.

The ten ASEAN economies are likely to grow at a reasonable 4.4% in 2015 and 4.9% in 2016 during the transition to slower “new normal” world growth around 3.0% in 2015 and 3.6% in 2016. They are also planning to introduce an ASEAN Economic Community (AEC) by the end of 2015, forming an integrated production base and market of over 600 million people. Moreover, Malaysia, Thailand, Vietnam, and Brunei are active in the Transpacific Partnership (TPP) led by the United States which could create a huge trade bloc covering 40% of world trade. Achievement of AEC, an eventual TPP agreement, a strategic geographical location in dynamic East Asia, and skilled labor mean that ASEAN will be a magnet for foreign investment in manufacturing, services and infrastructure.

SMEs, defined as having less than 100 workers, make up most of the firms in ASEAN economies. They also contribute about 74% of total employment and about 41% of gross domestic product across these economies. These contributions, however, are not yet reflected in international trade, where high performing SMEs make up only 21% of direct exports across ASEAN economies. Arguing that SMEs can generate jobs, Indonesia and the Philippines are considering industrial policies and other state interventions to promote SMEs. However, there is a risk of government failure associated with such distorting, inward-looking policies. A better alternative would be financing SMEs to join supply chain trade while pursuing outward-oriented development strategies.

International trade itself has fundamentally changed in the 21st Century and is no longer about direct exports. Instead, trade increasingly means global supply chains where different production stages are located across geographical space and linked by trade in intermediate inputs and final goods. For instance, the Toyota Prius – a hybrid electric mid-size hatchback car – for the United States market was designed in Japan and is presently assembled there. But some parts and components for the Prius are made in Thailand, other ASEAN economies, and the PRC. SMEs can participate in supply chains initially as suppliers to large exporters and then gradually become independent exporters or investors. ASEAN’s entry into supply chains – led by Singapore, Thailand and Malaysia – partly accounts for its growth since the 1980s. ASEAN economies contributed 9.3% of world supply chain trade in 2013. More developed ASEAN economies, Malaysia and Thailand, have larger shares of their SMEs in supply chains than Indonesia, the Philippines, and Vietnam. Moderating growth in PRC means that ASEAN firms will have more business opportunities as suppliers to exporters, but also face competition from new entrants like India, Bangladesh, and Sri Lanka with cheap yet fairly skilled labor.

Adjusting SME business strategies can help to expand ASEAN’s role in supply chains. By clubbing together in industrial clusters, SMEs can also overcome some of the

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disadvantages of being small and rely on the benefits of interdependence. SMEs located in clusters can jointly finance a training center to upgrade skills or a marketing consultant to develop advertising strategies. Business associations can facilitate clustering by coordinating collective actions. Such clusters are popping up in countries across ASEAN. One successful example is Malaysia’s semiconductor cluster located in Penang and Sembilan which makes chips and microchips used in computers and other electronic goods. Smart business strategies – including mergers, acquisitions between high performing SMEs, and forming business alliances with multinationals – are also rational approaches for SMEs to become large firms.

One critical constraint affecting SMEs in ASEAN is their limited access to finance from commercial banks. The total credit gap – the difference between formal credit provided to SMEs and estimated SME financing needs – amounts to as much as \$52.8 billion. This figure includes \$11.8 billion for Indonesia, \$11.8 billion for Thailand, \$8 billion for Malaysia, \$7.1 billion for Singapore, \$4.3 billion for Vietnam, and \$2 billion for the Philippines.

Banks in ASEAN typically undertake more certain and profitable lending to consumers and big corporations. Accordingly, SMEs continue to rely on internal sources like their own savings, money lenders, and nonbanks for most of their financial needs. Banks lend little to ASEAN SMEs partly because many banks are not designed to lend to SMEs. Banks do not know how to properly evaluate working capital requirements of SMEs and their investment projects. Accordingly, banks use stringent collateral requirements for SME lending going beyond a company’s fixed assets to the personal assets of SME entrepreneurs. Policy options include permitting the use of nontraditional collateral (like non-fixed collateral and stock) to secure loans and working with business associations to ratchet up peer pressure. In SME clusters in Japan, peer pressure within a network of SMEs has proven effective in loan repayment.

Improving credit assessment for SMEs – to separate out high-performing SMEs worthy of lower interest bank loans – is also important. Most ASEAN economies lack independent market institutions capable of rating the credit worthiness of SMEs. Establishing a domestic credit bureau for SMEs as a public-private partnership is useful. Later, this institution could become an independent company.

Furthermore, banks require business and financial plans. Many of the SMEs lack the capacity to prepare these plans. SMEs use a single entry accounting system; the banks expect to see something more complex. Investing in financial literacy for SME managers is useful. Financial literacy programs in high schools and universities along with short financial literacy courses for SME managers are options. More generally, ASEAN economies should pursue creating sound and effective banking systems which will increase the supply of lending, including for supply chain focused SMEs. Encouraging competition among banks is vital through privatization of state-owned banks and facilitating the entry of reputable foreign financial firms. Enacting strong competition laws provides a level playing field for domestic and foreign financial institutions alike and effective central bank regulation of commercial banks supports deep financial systems.

In an era of moderating growth, ASEAN and its SMEs involved in supply chains represent an opportunity for investors and for sustaining growth. There is no panacea to finance such SMEs. But there is much to be done: change collateral laws and requirements, improve credit assessment for SMEs, invest in financial literacy and education, and expand banking systems. A more effective and inclusive system of commercial bank finance in ASEAN economies is a better alternative to heavy handed and risky industrial policies favoring SMEs.

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