Chapter 2

Best Policy Practices for Internationalization of SMEs' Trade and Investment for ASEAN and East Asia

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CHAPTER 2
Best Policy Practices for Internationalization of SMEs' Trade and Investment for ASEAN and East Asia

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There are significant potential benefits to internationalization of small and medium-sized enterprises (SMEs), particularly for the Association of Southeast Asian Nations (ASEAN) and East Asian markets. Together, these will continue to constitute the fastest-growing region in the global economy. However, SMEs are constrained by considerable and diverse barriers to internationalization. There is a wide range of 'best policy practices' to support firms in overcoming such barriers that can guide the region's decision makers. At the same time, effective policies and programmes for SME internationalization in ASEAN and East Asia will have to be responsive to the emerging global and regional economic environment that will differ significantly from the growth years of most of the first decade of the 21st century. Against this backdrop, a simple framework is presented for SME internationalization and for considering examples of existing best policy practices. Areas requiring further attention in a changing regional environment are also identified. These include trade and supply chain finance; integration of SMEs as suppliers into global and regional value chains; thinking beyond exporting to innovating for Asian emerging markets, but in ways that differ from traditional concepts of innovation; and regional initiatives to support SME internationalization.

Key words: SME internationalization; best policy practices for SME internationalization; SMEs and frugal innovation; SMEs and global value chains

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1. Introduction and Overview[1]

This paper aims to identify best policy practices for the internationalization of small and medium-sized enterprises' (SMEs') trade and investment for the Association of Southeast Asian Nations (ASEAN) and East Asia, with particular focus on ASEAN firms. Section 2 discusses the potential benefits of internationalization ('why'), and different ways SMEs can internationalize ('how'). If, as the discussion suggests, there are significant benefits to SME internationalization, then why is it that more of the region's SMEs with the potential do not follow such strategies? SMEs are constrained by significant barriers to internationalization, as discussed in Section 4. The best policy practices for SME internationalization have to support firms in overcoming such barriers. They must also do so in the context of an evolving global and regional economy. That is, the best policy practices for SME internationalization for ASEAN and East Asia will also have to be responsive to the changing characteristics of these economies over the medium and longer term. Understanding the likely characteristics of ASEAN and East Asia as markets is particularly important at this time, since the global and regional economy are likely to look very different in the coming decades from the growth years of most of the first decade of the 21st century: in many ways the past may not be the best guide to the future. This is the focus of Section 4. Against this backdrop, Section 5 presents a simple framework for internationalization and for discussion of what are considered related best policy practices. The concluding Section 6 suggests issues and approaches to complement traditional best practice for SME internationalization for a changing ASEAN and East Asian environment.

[1] This paper builds on an earlier paper by Abonyi and Supapol (2012), also prepared for the Economic Research Institute for ASEAN and East Asia (ERIA).

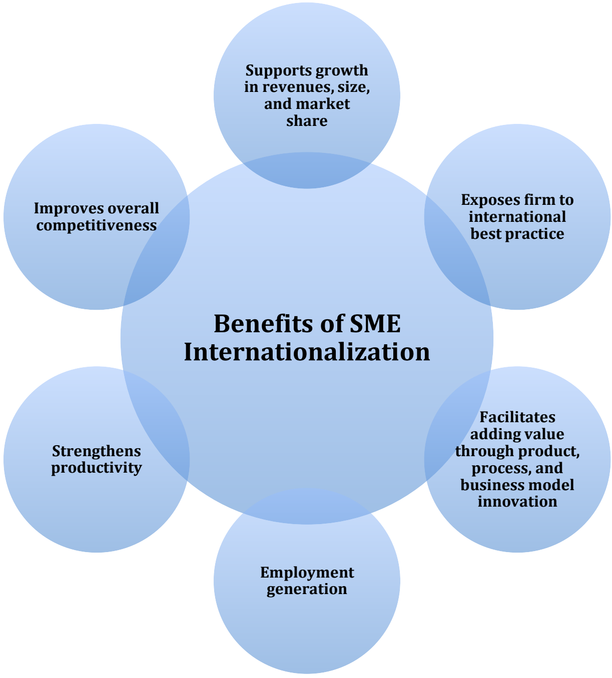
2. Importance of SME Internationalization

2.1. Why Internationalize

In general, internationalization enhances competitiveness, reinforces growth, and supports the long-term performance and sustainability of firms. For example, in European Union (EU) studies, internationally active SMEs report employment growth of 7 percent versus 1 percent for SMEs only active in domestic markets; and 26 percent of internationally active SMEs have introduced new products or services for their sector and in their country, compared with the average for all SMEs which is three times lower (Roland Berger, 2013). In short, exporting SMEs generally outperform their non-exporting peers.

The ability of SMEs to export is an indication of their competitiveness in global markets. It exposes firms to international best practice, and strengthens the possibility of adding value through innovation by improving products, production processes, and business models; can improve productivity through the adoption of new technology and know-how; and supports increasing sales, employment, and growth in revenues and market share, including through offsetting or 'smoothing' business cycles in different markets (see Figure 2.1) (OECD, 2010; 2013).

Figure 2.1: Benefits of SME Internationalization



It is important to note that most SMEs, particularly smaller ones, focus only on local or national markets, and do not consider 'going international', seeing it as unnecessary, costly, and risky. Many of these enterprises are low-tech, low value-adding firms—such as greengrocers, dry cleaners, and the local noodle stands— whose owners' main goals are to secure a stable income: to provide a route out of poverty for people with limited education, capital, or experience. Internationalization is fundamentally an entrepreneurial activity that requires recognition of potential opportunities and a corresponding readiness to undertake new types of activities that require new skills and capabilities, and entail taking on more risk, e.g., entering new markets, and developing and marketing new products.

2.2 How to Internationalize

Internationalization involves increasing direct and/or indirect linkages to international markets and cross-border operations. Policy attention is often focused on exporting in terms of selling goods and services directly to final customers in international markets. However, internationalization is much wider and can involve a variety of modes, including direct and indirect exports; licensing; franchising; joint ventures; strategic alliances; mergers and acquisitions; establishment of wholly owned subsidiaries in foreign markets; and international subcontracting by exporting, or by supplying international firms/buyers in the domestic market, but subject to a variety of international standards and requirements. SMEs are likely to serve international markets from a domestic production base through direct or indirect exporting, including as suppliers in global value chains (GVCs) to domestic or international firms, a particularly important route to markets in key industries.

The type of policy attention and support SMEs may need depends on their method of internationalizing. For example, there are likely to be significant differences in the needs of an operating SME seeking to export existing products for the first time to final customers in China; an SME looking for international buyers in particular value chains, e.g., electronics or garments; and an entrepreneurial SME that has an idea for innovating a new type of product for new customers in China.

On the 'supply side', the internationalization of SMEs increasingly takes place through participation as suppliers at various stages in GVCs. In general, reaching international markets is challenging for SMEs. The fragmentation of production creates new opportunities for the supply of products (e.g., parts, components) and services, through linkages with larger firms and foreign buyers and affiliates, in a wide range of industries and value chains, e.g., electronics, automotive, garments, agro-industry. Participation in GVCs can bring both growth opportunities and increasing stability of demand to SMEs. It provides easier access to key inputs, including information on markets, technology, and best practice; and allows firms to increase productivity, expand markets, and strengthen the capacity for innovation. However, to be a supplier in GVCs places significant demands on SMEs' skills, managerial and financial resources, and capacity to meet a multiplicity of international standards. More fundamentally, to be such suppliers, SMEs must be internationally competitive. Therefore, a basic challenge of internationalization through participation in GVCs is to loosen constraints on SME competitiveness (e.g., productivity) (ECLAC/AL – INVEST, 2013).

On the 'demand side', ASEAN and East Asia present opportunities for SMEs to innovate in new ways for new types of markets and consumers. The international economic environment is likely to be characterized in the coming years by continuing slow growth, particularly in developed economies, with relatively faster growth in the ASEAN and East Asia region (Section 4). But these markets differ significantly from developed economies, the traditional final markets for the region's (manufacturing) enterprises, e.g., substantially lower disposable incomes, fragmented markets, and large rural populations even as urbanization accelerates. This presents opportunities for entrepreneurial and innovative SMEs to develop new products and services, production processes, and business models, particularly suited to these markets.

SMEs can internationalize, or access markets, in ASEAN and East Asia in three general ways: (1) direct sales of final goods and services, exporting to 'retail' customers (business-to-consumer, or B-C); (2) as suppliers in regional production networks within the framework of GVCs—that is, selling parts, components, and tradable services to other enterprises who use them as inputs in their production and business systems (business-to-business, or B-B); and (3) innovating for new types of markets and retail customers whose characteristics differ significantly for developed economies, the traditional markets for the region's firms (business-to-[new types of] consumer). The three ways of internationalizing involve the following:

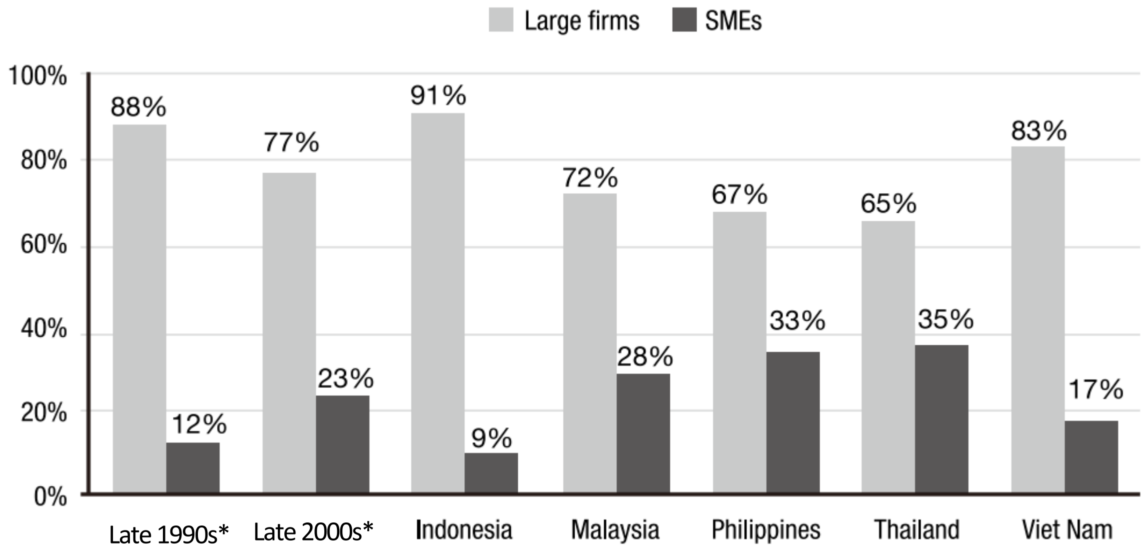
- *SMEs exporting existing products/services to ASEAN and developing East Asia final consumers (B-C)* involves selling (existing) goods and services to final consumers in a growing market. As discussed in Section 4, the region presents an expanding customer base characterized by increasing disposable incomes and rising consumer expenditures, supported by a demographic shift in a number of countries to a younger, better educated, and increasingly urbanized population. Therefore, the region presents expanding opportunities for SMEs to export existing products and services to growing regional markets, including new types of consumers.

- *SMEs as suppliers in production networks (B-B)* provide intermediate goods (e.g., parts, components, and services) to other firms within ASEAN and East Asia that are, in turn, supplying regional and global markets. The buyers of the output of the region's SMEs are generally multinational enterprises that may or may not originate in ASEAN and East Asia, and are international in their operations within the framework of GVCs, e.g., electronics and information technology (IT), garments, automotive. As discussed in Section 4, this has been a key driver of growth in the region through expanding parts and components trade for final (developed) markets outside Asia, with China in a key intermediating role. Even with their slowing growth, developed economies are expected to continue to play a key role as final markets for the region's exports. At the same time, regional production networks are likely to increasingly focus on growing numbers of consumers within ASEAN and East Asia. Serving these markets as suppliers in regional production networks within the framework of GVCs will therefore require SMEs to have the capabilities to become suppliers within such networks, including starting at lower tiers, and to upgrade over time.

- *SMEs innovating for Asian emerging markets:* As noted, the expanding regional market and consumers will have different characteristics from richer consumers in developed economies, the traditional final markets for the region's exporting firms (discussed in detail in Section 4). Asian emerging market customers (i.e., in ASEAN and developing East Asia) for final products will therefore require first an understanding of the needs and constraints of these consumers; then the capacity to competitively provide goods and services that respond to such needs and constraints. This, in turn, requires increased capabilities of the region's firms (SMEs) for product market innovation that accommodates both rising aspirations and existing constraints, often referred to as 'frugal innovation'. Furthermore, the development of innovative products for regional markets may provide SMEs opportunities to also serve global market niches, or 'reverse innovation'.

The benefits of internationalization seem clear, and various options are available for SMEs, yet many with potential do not internationalize. Over 90 percent of companies in Asia are SMEs. They contribute more than two-thirds of employment; over 60 percent of gross domestic product (GDP); and are a significant source of product and process innovations. Yet they generate only around 30 percent of Asia's exports, though with wide variations among the countries of the region. For example, the average SME export share of five ASEAN economies (Indonesia, Malaysia, Philippines, Thailand, and Viet Nam) is about 23 percent (Figure 2.2), compared with that of East Asian economies which range from 40 percent to 60 percent, with China's SMEs contributing nearly 70 percent of the nation's exports (UNESCAP, 2012a; APEC, 2014; Sato, 2013).

Figure 2.2: Share of Selected ASEAN SMEs and Large Firms in Exports



Note: * = 5 ASEAN Economies (Indonesia, Malaysia, Philippines, Thailand and Vietnam)
Source: Sato (2013).

Most SMEs, including many with the potential and/or existing capability to internationalize, do not do so. This is because internationalization is constrained by many barriers that usually involve significant costs, uncertainty, and risks to all firms, particularly SMEs. This is the focus of the next section (3).

3. Barriers to Internationalization of SMEs for ASEAN and East Asia

The region's SMEs face various barriers or constraints with respect to internationalization for an evolving ASEAN and East Asia, either as producers for the region's consumers or as suppliers in regional production networks in the context of GVCs. These barriers define, in part, the basis for policy initiatives intended to support SME internationalization. It should be noted that the barriers to internationalization are in the context of a still wider set of constraints that SMEs face in general, which limit their operations and performance, as discussed elsewhere (e.g., Abonyi and Supapol, 2012). A number of studies have identified barriers to internationalization, including for SMEs (e.g., Leonidou, 2004; OECD - APEC, 2007; APEC, 2013). Many of these, following Leonidou (2004), classified existing barriers as internal and external, the approach also adopted here.

- *Internal barriers* are generally seen as the most important, and relate to firm-level capability and resource constraints, such as business culture and skills not well suited to internationalization; financial constraints at various stages of internationalization; difficulties with product standards and certification; constraints on accessing and using information and/or knowledge related to export markets and customers (final consumers or businesses as buyers in GVCs); lack of familiarity with cross-border marketing and distribution channels; limited capacity related to undertaking and/or managing logistics requirements; limited capability for effective promotion of the firm and its products; and constraints on product and process innovation, including related technology acquisition and adaptation.

- *External barriers* relate to the business environment both nationally and in international markets, such as (domestic) government rules, regulations and procedures related to exporting, importing, and procurement; rules, procedures, and requirements of firms providing key cross-border supporting services, e.g., banks, shippers, insurance companies; limited effective (national) initiatives supporting SME internationalization (e.g., export promotion financing); gaps and inefficiencies in national and cross-border infrastructure and logistics systems; inconsistencies among different national customs rules, regulations, and procedures; continuing protection, including non-tariff barriers in key regional markets; and general (national) constraints on SME operations and performance.

The wide range of barriers SMEs face with respect to internationalization is summarized in Table 2.1. A number of factors are particularly important, including (1) managerial mindset and organizational culture, (2) information, (3) financing, (4) role of clusters, (5) differences in level of development among the region’s economies, and (6) stages of internationalization and their implications.

Managerial mindset and organizational culture: A key constraint on SME internationalization is managerial mindset and organizational culture. Most SMEs, particularly smaller firms, focus only on local or domestic markets. They do not consider 'going international', seeing it as unnecessary, too costly, too complicated, and too risky. Furthermore, delays and uncertainty in implementing the ASEAN Economic Community (AEC) 2015 has limited its credibility with the region's business community (Abonyi and Supapol, 2012). Therefore, a critical first step to facilitate SME focus on ASEAN and (emerging) East Asia involves communicating effectively the potential benefits of internationalization; what it takes to internationalize; why it may be a good idea even for smaller firms; key challenges and constraints; support for an assessment of a firm's potential for internationalization; and communicating credibly actual and expected progress in implementation and expected tangible benefits of AEC 2015. In this context, easily accessible case studies and sharing the experience of successful SMEs, ideally in the same value chain, can be particularly useful.

Information: The primary constraint cited by SMEs on accessing and competing on regional (e.g., ASEAN, East Asia) markets is lack of information, even in the current era of extensive and easily accessible information. This includes information on market characteristics and potential customers; on existing regional and bilateral trade and investment agreements and their business implications (see, for example, Abonyi and Supapol, 2012); and on regional rules, regulations, and procedures. Furthermore, many SMEs have limited ability to use existing data and information, and therefore how information is presented is a key factor in whether and how it will be used. In the context of the discussion (in Section 4) of the evolving characteristics of ASEAN and (emerging) East Asia, deeper knowledge of potential customers in the region is particularly important, as the challenge is to think beyond exporting, to innovating for the needs and circumstances of the particular customers in these changing markets.

Financing: Access to financing is a general constraint for small firms, and one of the two most-often-cited constraints (along with information) with respect to responding to international opportunities. It is particularly important given the bank-dominated financial systems in the region that constrain available financing for new ventures by small firms. The region's banks generally base lending decisions on collateral and credit history, and less on a business plan and projected future cash flows. This puts SMEs at a particular disadvantage, especially with respect to perceived higher risks of internationalization, given their limited collateral and credit track record. Access to finance is even more difficult for entrepreneurial SMEs and early stage ventures (e.g., new product development), where uncertainty and risks are higher still. A critical constraint specifically for internationalization is access to trade and supply chain finance, further constrained in the aftermath of the Global Financial Crisis of 2008 (discussed in Section 6). This includes difficulties for SMEs to get payment obligations from banks' guarantees, such as letters of credit, critical to trade. Therefore, policy initiatives can play an important role in providing access to financing for internationalization either directly (e.g., export finance programmes) or by reducing the perceived risks of commercial lenders and investors. In this context, familiarizing SME managers with different forms of export-related financing is particularly important (e.g., letters of credit, factoring, leasing).

Table 2.1: Barriers to SME Internationalization

<table>
<tr><th colspan="2">Barrier</th><th>Factors</th></tr>
<tr><td rowspan="9">Internal</td><td>Managerial mindset</td><td>• Limited appreciation of potential benefits of and tangible opportunities for internationalization</td></tr>
<tr><td rowspan="7">Information</td><td>• Limited information on markets, consumers/buyers</td></tr>
<tr><td>• Problems with using available data/information</td></tr>
<tr><td>• Limited understanding of market conditions, and customers/context (e.g., economic, socio-cultural)</td></tr>
<tr><td>• Difficulties seeing foreign business opportunities</td></tr>
<tr><td>• Constraints on contacting foreign customers</td></tr>
<tr><td>• Limited knowledge of related government initiatives</td></tr>
<tr><td>• Limited awareness of supporting regional initiatives (e.g., ASEAN, regional free trade areas/agreements)</td></tr>
<tr><td></td><td>• Shortage of working capital</td></tr>
</table>

	Finance		• Limited access to trade and supply chain finance
			• Constraints on creditworthiness
			• Shortage of start-up/early-stage financing
	Functional		• Lack of managerial skills for internationalization
			• Limited managerial time
			• Insufficient trained personnel for foreign business
			• Constraints on production capacity/scale
			• Difficulty meeting product/process standards
			• Constraints on product and process innovation for new markets and customers
	Logistics		• Lack of logistical (e.g., shipping) capabilities
			• Lack of warehousing facilities in foreign markets
			• Excessive transportation/insurance costs
	Marketing	***Price***	• Ability to offer competitive pricing to customers
			• Constraints on providing credit to customers
		Distribution	• Limited knowledge of foreign distribution channels
			• Constraints on using foreign distribution and marketing channels
			• Problems identifying and arranging reliable foreign market representation
		Promotion	• Constraints on effective promotional activities (e.g., to retail customers, to GVC-related buyers)
	Procedural		• Lack familiarity with foreign procedures, documentation
			• Difficulties communicating with foreign customers

External		• Constraints on collecting payment (e.g., time)
	Government	• Limited effectiveness of support for key aspects of internationalization (e.g., financing, information)
		• Limited effectiveness of communications on existing support for internationalization
		• Differences in perspective on firm-level needs
	Market	• Strong competition in foreign markets
		• Fragmented foreign (national) markets
		• Unfamiliar foreign business practices and language
		• Barriers, e.g., tariff, and especially non-tariff barriers
	Business Environment	• General domestic SME-related business environment, e.g., business registration, customs and tax refund, technology acquisition, support for innovation
		• State of domestic infrastructure and logistics to support international business
		• Limited effective support for enterprise clustering
		• Foreign currency exchange risk
		• Difficulties with procedures of firms supporting cross-border business, e.g., banks, insurance companies, shippers

Source: Adapted and expanded from Leonidou 2004.

Role of enterprise clusters and networks[2]*:* Research has shown that not only is the smallness of SMEs an important constraint but also their limited interaction and linkages with other enterprises, which are more easily available to large firms. This is a particularly important constraint on internationalization, which requires more complex capabilities and resources

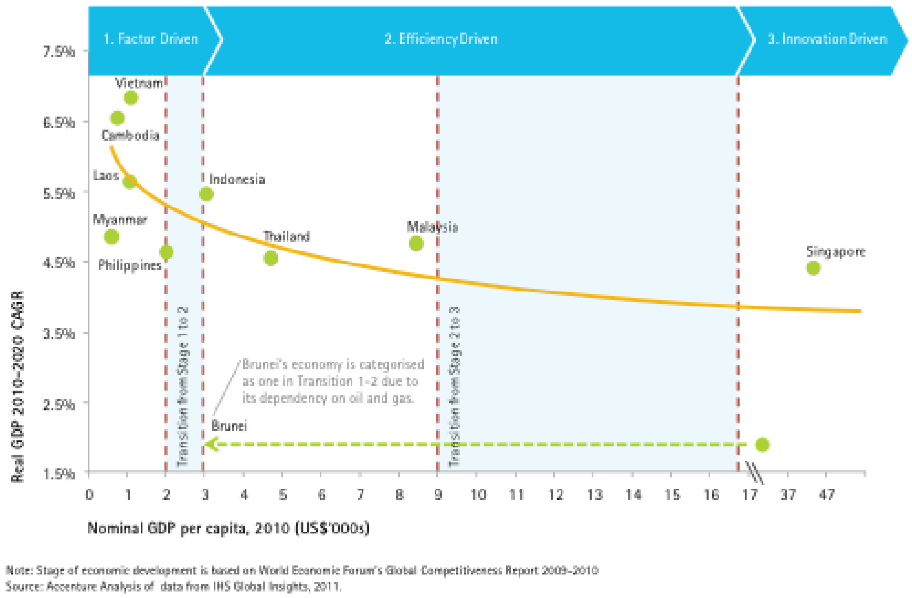
[2] Based on Abonyi and Supapol (2012).

than purely domestic operations. It is also important in attracting international firms seeking competitive suppliers, who prefer to deal with groups or clusters rather than with individual small enterprises (e.g., BCG, 2009). Focused cooperation among SMEs, and between SMEs and larger domestic and foreign firms, and other supporting institutions (e.g., government agencies, research and education institutions), can help loosen constraints on accessing and competing in regional markets, and entering into and upgrading within regional production networks and GVCs (Abonyi, 2007). Enterprise clusters and networks can increase *productivity and efficiency* by providing easier access to specialized inputs and services, for example, support for meeting international standards and certification; enable rapid diffusion of learning and best practices, for example, on entry strategies to foreign markets; and encourage differentiation and specialization among firms to improve productivity. Clusters can help in the *commercialization of ideas* and *in new business formation*, by making more apparent opportunities for new companies and for new lines of business, including for international markets; and by providing a concentrated environment with available skills, suppliers, and buyers—including for larger enterprises and international buyers. Clusters and networks can also *stimulate and enable product market innovation* by helping to more easily identify unmet needs, encouraging the presence of a wide range of suppliers and institutions to assist in knowledge creation; and by providing linkages and partnerships among innovative enterprises.

Different levels of development among ASEAN economies: The different levels of development among the region's economies are reflected in measures such as size of GDP and per capita incomes. Porter's framework (2003) is useful in terms of the differing challenges of the region's SMEs (Figure 2.3). The CLMV countries—Cambodia, Lao PDR, Myanmar, and to an increasingly lesser extent Viet Nam—are at the factor-driven stage, highly dependent on natural resources, largely unskilled labour, and capital investment in basics such as infrastructure, to stimulate growth and strengthen competitiveness. *A key challenge here is to strengthen the capacity of SMEs to enter into GVCs and access international markets, as an important means to diversify the structure of their economies.* Malaysia and Thailand are at the efficiency-driven stage of development, requiring better production processes to improve overall productivity and competitiveness, and to increasingly focus on transition to innovation-driven development, as they face a 'middle-income trap'. *For these economies a key challenge is to expand the range of competitive SMEs for international markets, and strengthen not only their export capabilities but also their capacity to innovate products and services appropriate to the particular markets and consumers of ASEAN and East Asia (e.g., China).* The Philippines and

Indonesia have characteristics of an efficiency-driven economy, but also retain key features of the factor-driven stage. Singapore is ASEAN’s most advanced economy with the highest GDP per capita, and is considered to be an innovation-driven economy, relying on sophisticated production processes and innovation to produce new products and services to sustain higher wages and associated standards of living. Different levels of development present differing policy challenges for supporting SMEs in general, and internationalization in particular. *For less developed economies, there is more a need for overall strengthening of SMEs. For internationalization, differences are mostly of policy emphasis, rather than basic differences in needs* (see Section 6).

Figure 2.3: Stages of Economic Development of ASEAN Economies



Source: Accenture (2011).

Stages of internationalization: Internationalization involves different stages that involve diverse, if overlapping, challenges and constraints, requiring different policy emphasis. The *preparation stage* involves pre-internationalization issues. For example, at this stage a key requirement is to make a credible case for internationalization; and key information needs relate to the benefits, challenges, and ‘best practice’ of internationalization; and identification and initial understanding of potential markets and customers. Basic capacity constraints on internationalization (e.g., managerial mindset, skills), and understanding of market entry requirements and options, are especially important. Constraints on working capital financing are of particular concern. The *active engagement stage* involves the start of the implementation of internationalization activities. Key constraints at this stage relate to initiating contacts and 'getting to know' foreign markets and foreign buyers, e.g., through overseas trade offices, trade fairs, and missions; constraints on understanding and using cross-border logistics; knowing the rules and regulations for operating in foreign markets; and trade and supply chain finance. The *growth and expansion stage* involves strengthening and enlarging product market position. Key constraints at this stage relate to improving competitiveness, expanding production capacity, expanding knowledge of relevant range of standards and certifications, and diversifying distribution and marketing channels. There is a relationship between levels of development and stages of internationalization in that a country at a lower level of development such as Myanmar, compared with a more developed economy such as Thailand, will have firms mostly at the initial preparation stage, facing related constraints. More fundamentally, less developed economies face greater challenges and will have to put relatively more emphasis on basic and overall strengthening of SMEs, as a precursor to the pre-preparation stage for internationalization, an issue not addressed in this paper.

4. ASEAN and East Asia: Challenges and Opportunities for SMEs

4.1. Introduction

In order to understand the challenges and opportunities, and related policy requirements of internationalization for the ASEAN and East Asia region, it is important to look at key characteristics of the region as a market, and its likely evolution. It is particularly important to do so with some care, since *the performance of the global and regional economy is likely to differ substantially in the coming years from the rapid growth that characterized the region during most of the first decade of the 21st century*. *Therefore, what is considered best policy practice for SME internationalization at this time will need to be adjusted for policy measures to respond effectively to likely future conditions.*

In general, SMEs are faced with opportunities and challenges on two tracks: (1) Slow growth developed economies, in particular the United States (US) and the EU, the region's traditional final export markets, will continue to play a key role over the medium term and beyond, especially for GVCs and related production networks involving the intra-regional trade of parts and components aimed at producing final goods for these external markets. (2) At the same time, an expanding regional market will present significant growth opportunities for the region's firms. However, the ASEAN and East Asia markets and consumers will continue to have very different characteristics than those in developed economies, requiring innovations in products, production processes, and business models.

4.2. A Slow Growth Global Economic Environment

In general, the international economic environment is likely to be characterized in the coming years by continuing uncertainty, volatility, and change. Growth prospects of the world economy are clouded by continuing structural imbalances and fragilities, reflected in the Global Financial Crisis of 2008, that to a large extent are still unresolved. The markets of the US, the EU, and Japan have been driving the ASEAN and East Asia region's growth, development, and structural transformation, including in the last decade. These developed economies, especially the EU, are continuing to face slow and uncertain growth, which together with a slowing China is impacting significantly on the region's economies through more uncertain global trade and financial conditions. This is the 'new normal' of global growth (Table 2.2).

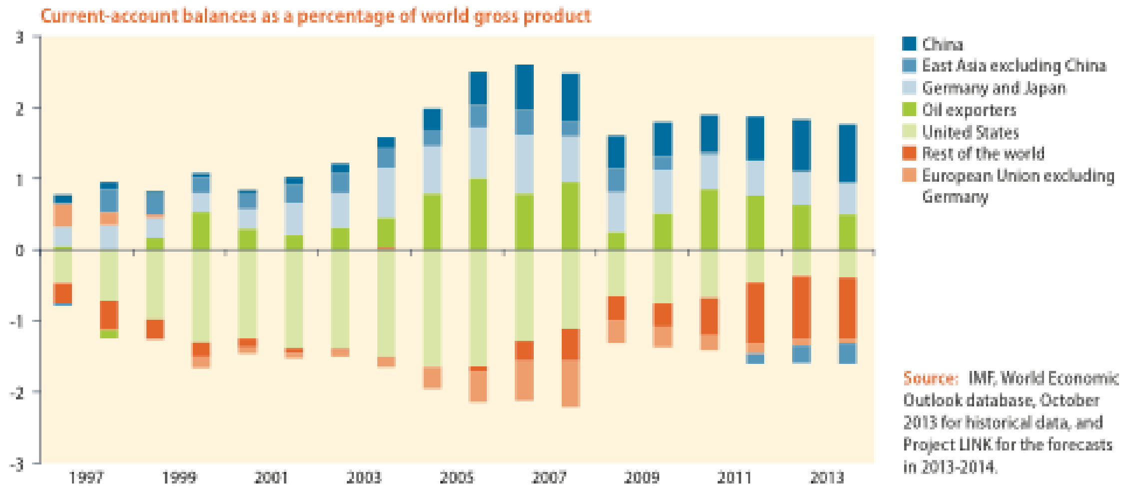
Table 2.2: The 'New Normal' of Global Growth (2006, 2007, 2009–2016)

	2006	2007	2009	2010	2011	2012	2013	2014	2015 (P)	2016(P)
World Output	5.1	5.0	-0.7	5.1	3.9	3.4	3.3	***3.3***	***3.5***	***3.7***
United States	2.8	2.0	-3.1	2.4	1.8	2.3	2.2	***2.4***	***3.6***	***3.3***
Euro Area	2.8	2.6	-4.4	2.0	1.5	-0.7	-0.5	***0.8***	***1.2***	***1.4***
Japan	2.4	2.1	-5.5	4.5	-0.6	1.5	1.6	***0.1***	***0.6***	***0.8***
Developing Asia	9.9	10.0	7.0	9.5	7.8	6.7	6.6	***6.5***	***6.4***	***6.2***
People's Republic of China	11.6	11.9	9.2	10.4	9.3	7.7	7.8	***7.4***	***6.8***	***6.3***
India	9.8	9.3	5.9	10.1	6.3	4.7	5.0	***5.8***	***6.3***	***6.5***
ASEAN 5	5.7	6.3	1.7	7.0	4.5	6.2	5.2	***4.5***	***5.2***	***5.3***

Source: International Monetary Fund, *World Economic Outlook*, January 2015; October 2008.

Global economic growth between 1990 and 2010 was driven primarily by developed country spending on consumption, particularly in the US and the EU. This led to the emergence of large trade and current account imbalances. For example, the US generated large current account deficits, financed to a large extent by foreign central banks that accumulated large holdings of dollar reserves. Developing countries, primarily in East and Southeast Asia, particularly China, were on the other side of these transactions, accumulating large current account surpluses and reserves. That is, debt-driven expansion of developed economies (especially the US and the EU) created markets for the exports of ASEAN and East Asia, acting as a locomotive for major surplus countries (e.g., generally East Asia, including China and Japan, and Southeast Asia, as well as Germany). In the process, credit-fuelled consumption led to increasing financial fragility in the US and the EU. The result was the most serious post-war economic crisis in 2008 that is as yet unresolved.

Figure 2.4: Global Imbalances 1997–2014



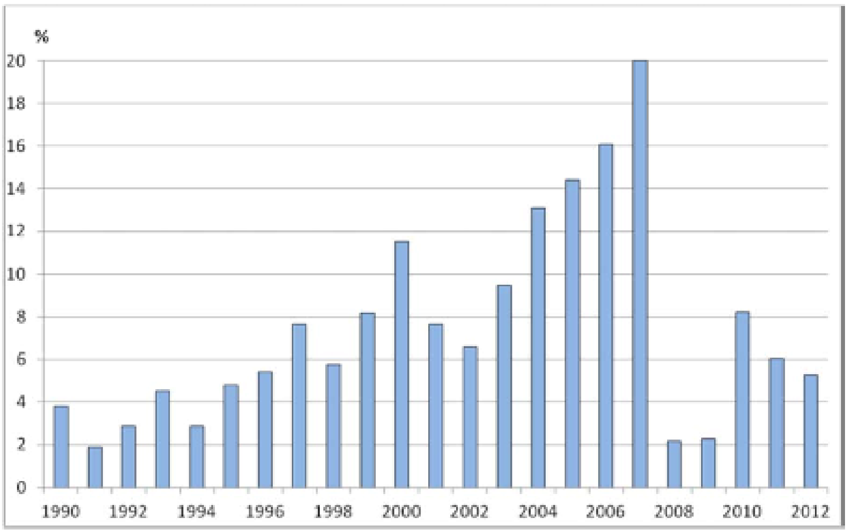
Source: United Nations (2014), *World Economic Situation and Prospects 2014*, Figure I.9, p.17.

The Global Financial Crisis (2008) resulted in significant adjustments in global trade imbalances, but it did not resolve their fundamental longer-term challenge (Figure 2.4). For example, developing Asia's surplus fell from $400 billion to $130 billion, and that of China from $350 billion to $210 billion or from 10 percent of GDP in 2007 to 2.6 percent of GDP in 2012; while the US current account deficit had fallen by $200 billion by the end of 2012 (IMF, 2015). However, sizeable global imbalances remain, creating further uncertainty for long-term global growth; with China and Germany as leading surplus countries, and the US and (parts of) the EU as the large deficit countries.

Significant global production and expenditure shifts are necessary to balance global trade flows. This will require major readjustment by both the leading global surplus economies, particularly China and Germany, and by the deficit countries of the US and the EU. The adjustment of global imbalances will have to involve fiscal consolidation in developed economies, and constrained private spending. *Therefore, developed economies will not provide the kind of expanding markets to the region's firms, as in the recent past*.

A similar picture emerges for capital flows. The Global Financial Crisis of 2008 reversed the private capital flows that have contributed significantly to the region's growth, leading to a contraction of credit in these economies. This was the result of increased global risk aversion, and preference for safer assets; and to a reduction in international bank lending (Figure 2.5). The weakening of private capital flows from the EU to emerging markets was particularly significant, falling from a high of $1,600 billion per year during 2004–2007, higher than US and Japan together, to around $300 billion during 2008–2011.

Figure 2.5: Aggregate Global Capital Flows (% of global GDP)

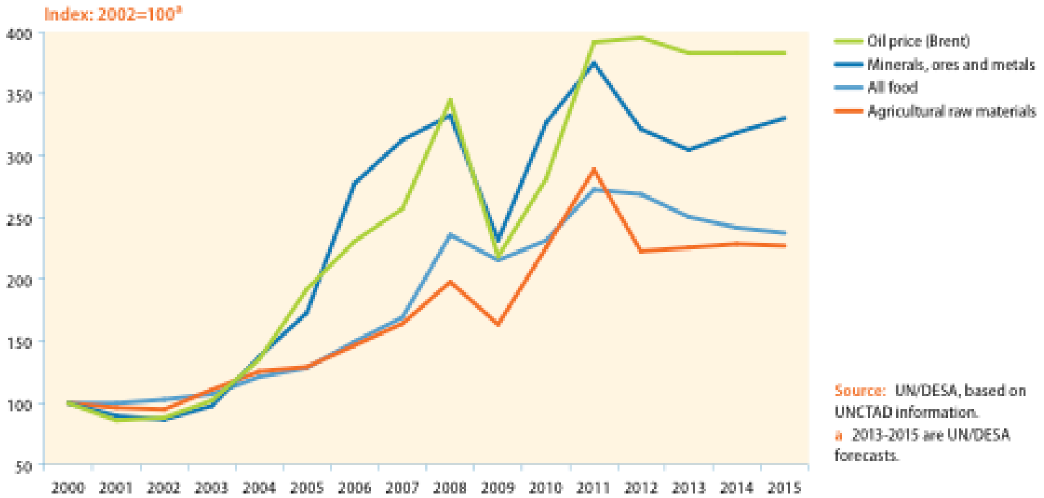


Note: Calculated as the average of gross capital inflows and outflows in USD divided by world GDP in USD.
Source: IMF World Economic Outlook database.

Source: Ollivaud, P and C. Schwellnus (2013), Figure 2, p. 9.

The Global Crisis also created downward pressure and instability in commodity prices, especially resources (Figure 2.6). This is, in part, the result of slowing global growth and related reduction in production and trade, particularly in China, the primary market for resources. Therefore, rapid and sustained price increases in recent years may not be a good guide to the future: the medium- and longer-term outlook for commodity prices is highly uncertain.

Figure 2.6: Price Indices of Commodities (2000–2015)



Source: UN, *World Economic Situation and Prospects*, 2014, Figure I.7, p. 15.

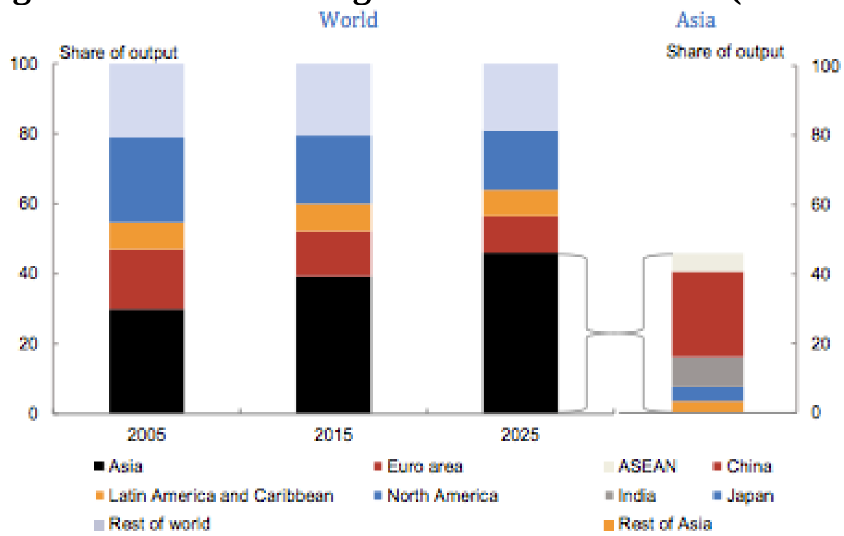
Following the global crisis growth continues to be weak; and there is expectation of prolonged sluggish growth of the global economy. Low growth of developed economies (US, EU, Japan) had been anticipated following the crisis. However, the slowing growth of (Asian) emerging economies was generally not expected.

4.3. Key Asian Emerging Economies: ASEAN and China

4.3.1 Increasing importance of the region's economies

In recent decades, Asian economies, particularly ASEAN and East Asia, have achieved remarkable growth and development, much of it facilitated by China for global (developed) markets. This reflected the region's close integration into the global economy through regional production networks, within the framework of GVCs, supported by continuous improvement in business environments and cross-border linkages. The region's increasing overall economic importance is reflected in its growing relative aggregate share of global GDP (Figure 2.7).

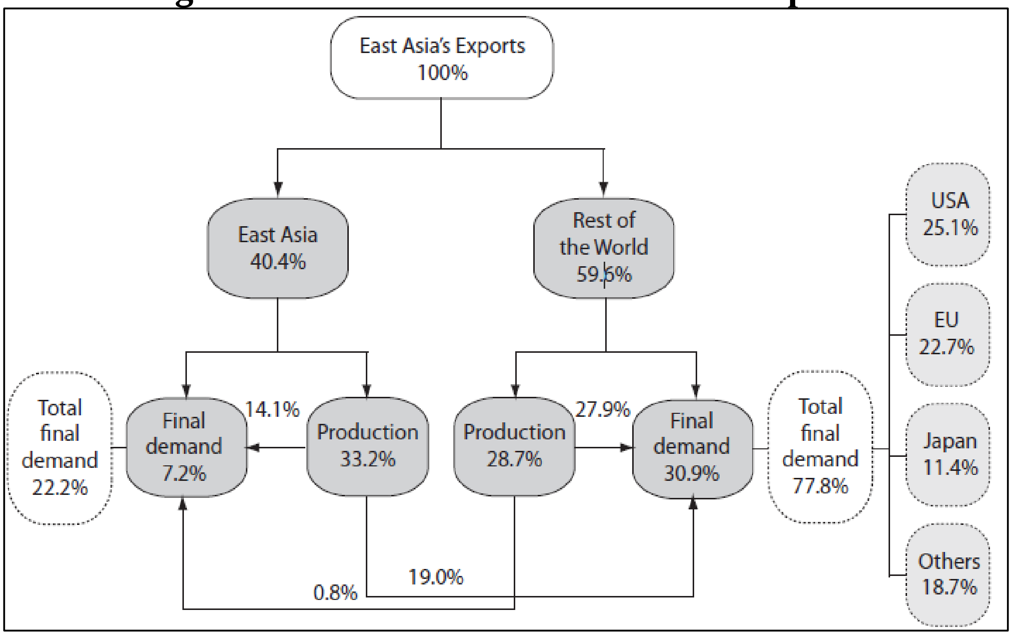
Figure 2.7: Asia's Rising Share of Global GDP (in PPP)



Source: Australian Government (2012).

As noted, the growth of ASEAN and East Asia has been driven largely by consumer markets outside the region, primarily in the US and the EU. In this context, the expansion of intra-regional trade, the foundation of Asian growth and development since the Asian Financial Crisis (1997/1998), reflects the role of the region's firms in production networks within the framework of GVCs in key industries such as electronics. The overwhelming share of ASEAN's and East Asia's final manufactured exports are to consumers in developed economies outside the region, particularly the US and the EU (Figure 2.8). For example, ASEAN's intra-regional trade is only around 25 percent of its total trade.

Figure 2.8: Destination of East Asia's Exports



Source: Kim, S., J.-W Lee and C.-Y. Park (2010), Figure 3, p. 9.

For the region's growth rates to remain above world rates, production and output structure will have to increasingly focus on expanding regional and domestic demand. However, the characteristics of Asian emerging markets (e.g., ASEAN, China, and India) and their consumers are likely to remain in the foreseeable future very different from developed economies, requiring adjustments and innovation in products, production processes, and business models.

4.3.2 Asian emerging economies as a market (ASEAN, China)

In general, the 'new normal' in global growth will likely result in changing markets and consumers for the region's firms. Given slow growth in developed economies and relatively faster growth in emerging economies, particularly in ASEAN and East Asia, these consumers will play a greater role in driving growth in the region. With growing population and increased incomes, 40 percent of global consumer spending is to come from Asia by 2030, particularly ASEAN and China, and also India (Euromonitor various reports and updates). For example, in ASEAN, growing disposable incomes, leading to rising purchasing power, coupled with demographic shifts in some economies to a younger, better educated population—projected to reach 650 million by 2020, half of it under the age of 30—and increased urbanization, will create a consumer market with distinct needs and strong buying power, providing new opportunities for the regions' firms.

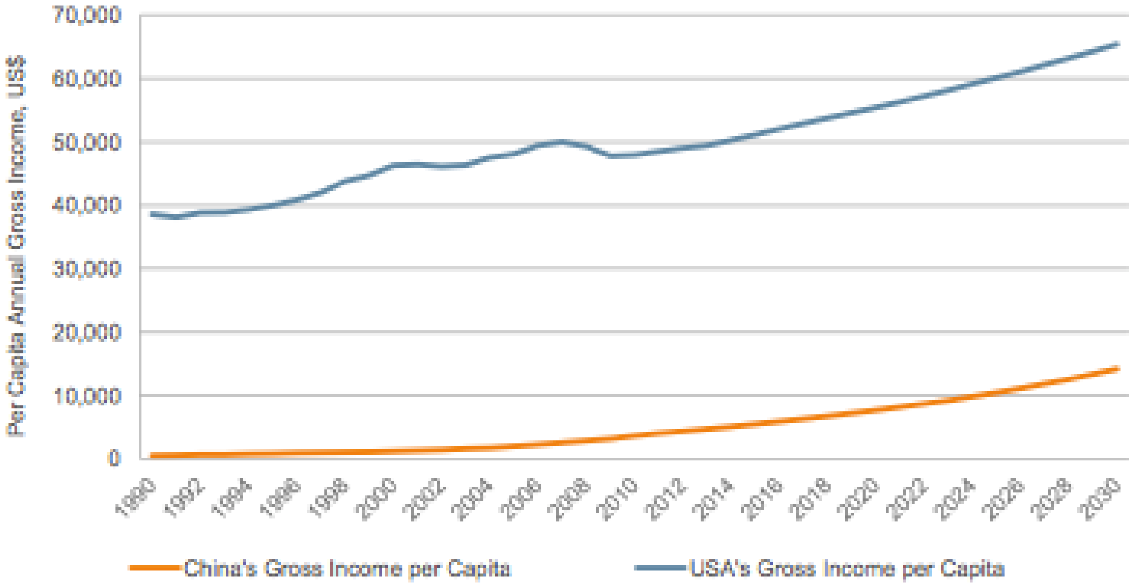
At the same time, although Asian emerging markets' (i.e., ASEAN, China, and India) aggregate weight in the global economy is increasing appreciably, spending levels in ASEAN (Table 2.3) and China (Figure 2.9) will remain considerably lower than those of developed economies such as the US, the region's traditional markets. A growing middle class notwithstanding, given present income levels and income distributions, lower income households will continue to be the backbone of the region's consumer economy. In addition, income inequality, fragmented consumer markets, and a high proportion of rural population, even with accelerating urbanization, will limit discretionary spending. Therefore, the Asian emerging economies represent a significant and growing market, but fundamentally different in nature from developed economies.

Table 2.3: Nominal ASEAN 6 GDP per Capita Compared with US GDP per Capita (in %)

Nominal GDP per capita (exchange rate adjusted)	2000	2010	2030
Indonesia	2.20	6.15	13.63
Malaysia	11.55	17.78	25.35
Philippines	2.84	4.22	5.50
Singapore	65.04	91.59	
Thailand	5.65	10.16	18.83
Viet Nam	1.12	2.44	5.47

Source: Based on Lawrence, R.Z. (2013), Table 5, p.6.

Figure 2.9: Comparing Per Capita Real Annual Gross Income in China and the US (1990–2030)



Source: Euromonitor (2014).

Over the longer term, income growth in Asian emerging markets (e.g., ASEAN and China) will generate a growing number of middle class consumers (US$5,000–15,000 annual incomes), with substantial aggregate buying power.[3] Therefore, the focus of manufacturing in Asian economies is likely to shift over the longer term from production, trade, and investment to serve consumers in advanced economies to supplying growing regional

[3] Middle class in emerging economies has different definitions. For example, the definition used by the World Bank is consumers with incomes of $10–$100 per day. However, business-oriented analysts such as Euromonitor and Accenture use the range of $5,000–$15,000 per annum. Given the focus of this paper on business development (SMEs), the latter definition is followed here, as the first potentially understates the important business factor that lower-income customers will continue to drive the growth of consumption expenditures in the region in years to come.

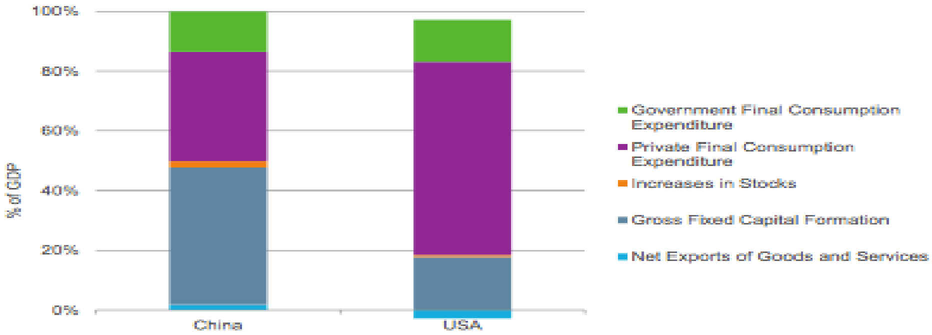
markets. But it will take considerable time before ASEAN and East Asian emerging economies, particularly China, are able to drive growth of the region, as have the US and the EU in recent decades.

4.4. Changing Regional Role of China

Given the central importance of China in the region's recent growth and production integration, its likely performance over the medium term is particularly important. China has become the largest single market for an increasing number of the region's economies, such as Thailand; and has accounted for much of the world's growth in demand for primary commodities. Therefore, the risks and uncertainty with respect to its economy are particularly important for the ASEAN and East Asia region.

China's growth has rested on massive investments in industrial capacity and related exports, made possible primarily through artificially low interest rates and low household income and consumption (as share of GDP). This investment-led growth was intensified in response to a sharp slowing of exports as a result of the Global Financial Crisis of 2008 and the slowing of developed markets (US, EU). Although this narrowed external imbalances by reducing the share of exports in GDP, it reinforced the gap between investment and private consumption. In particular, the share of private consumption in China's GDP had been constantly falling since the late 1990s, from over 55 percent to under 35 percent in 2013. A comparison with the US (Figure 2.10) illustrates the issue. This low level of consumption seems to be due less to very large household savings, and more to the low share of household income in GDP (e.g., Pettis, 2013). The gap between consumption and investment, and the resulting dependence on foreign markets, reflects an imbalance between wages and profits, between household and corporate incomes. This represents, in effect, a transfer from households to firms, particularly state-owned enterprises (SOEs) and state-linked firms, including to provincial and local governments. This is intermediated through a financial sector composed primarily of large government-linked banks, with artificially low interest rates that keep both returns on savings and the cost of funds for (e.g., SOE) investment artificially low, in the process leading to what is emerging as significant overcapacity in areas such as housing. Therefore, increasing consumption in China suggests challenging fundamental reforms in the basic structure of the economy and in key power relations (e.g., SOEs vs. households).

Figure 2.10: Comparing China and the US



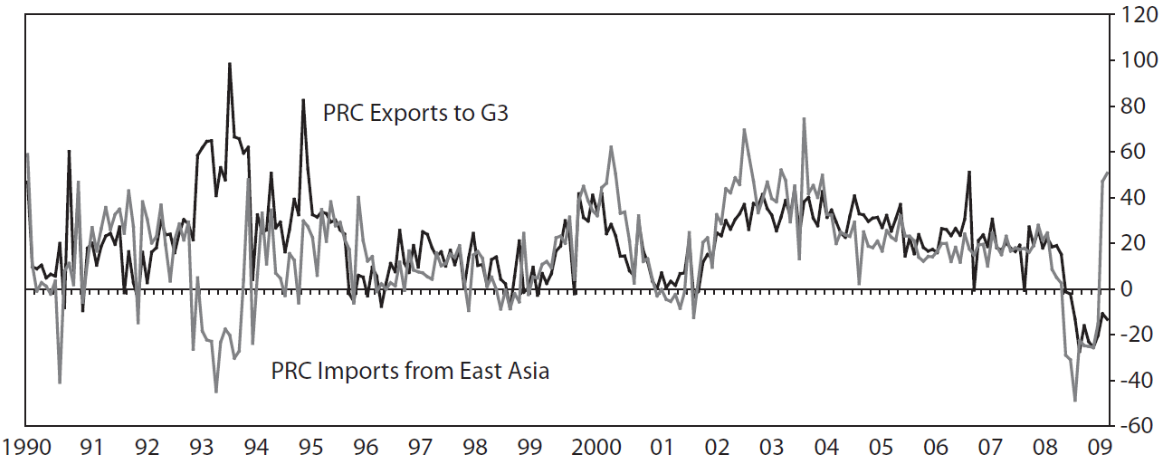
Source: Euromonitor (2014).

China is now shifting toward a rebalancing strategy involving raising the share of household income in GDP and the transition to sustainable domestic consumption-led growth. This means that over the medium and longer term, China is likely to settle into a lower growth path, far from the double-digit rates of recent years, as there is a gradual rebalancing of external and domestic sources of demand, and of domestic investment and consumption. The transition of China to a lower growth path in coming years implies that its demand for commodities would also grow much more slowly than in recent years.

Beyond the challenge of lagging domestic consumption, the import intensity of domestic demand not only in China but also in most ASEAN and East Asian economies is generally much lower than that of exports. This is the result of the close linkage of manufactured exports to production networks in GVCs, and the related dominance of parts and components in intra-regional trade; as well as of the large share of non-tradable services in private consumption. Similarly, the import intensity of investment is also greater than that of domestic consumption, particularly in economies with underdeveloped capital goods industries. Therefore, expanding domestic consumption of final goods within the region, and particularly their import content, presents challenges beyond increasing aggregate demand, given the region's existing economic and trade structure.

In this context, China is not likely to become a locomotive for the region's exports of manufactures in the foreseeable future, replacing the role of the US and the EU. Its emergence in recent years as the largest single export market for an increasing number of the region's economies reflects primarily China's key role as the destination for intra-regional trade in parts and components for final assembly of products for external markets, mostly the US and the EU (Figure 2.11). Therefore, while the China's economy plays an important role in importing the region's manufacture of parts and components for exports, it is not a major market for its final products.

Figure 2.11: Role of China Linking East Asia to Developed Markets



Note: East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; and Thailand.
Source: Kim, S., J.-W Lee and C.-Y. Park (2010), Figure 4, p. 10.

For processing (manufactured) exports, the value share of Asian developing economies in China's exports is in the range of 75 percent to 80 percent, with around 50 percent of parts and components coming in recent years from East Asia.[4] Since, processing exports are a very large share of China's exports to the US (close to 80 percent), and parts and components account for a large share of total manufactured exports of the region's economies to China, a slowdown of China's exports to the US and the EU is likely to strongly impact the region's economies. This is particularly the case as the US and the EU account for a much higher proportion of exports of China (around 25 percent each) than for the exports of ASEAN countries such as Thailand and Malaysia. That is, since an important part of the exports of the region's economies to China are linked via production networks to China's exports of final goods to the US and the EU, the overall exposure of these economies to a sustained slowdown in the US and the EU is much greater than is suggested by their direct exports to these markets.

[4] This section draws on Akyuz (2013, 2012); see also Pettis (2013).

Furthermore, while China is a major importer from East Asian economies through regional production networks within the framework of GVCs, it is not a major market for their final products. A significant share of these Chinese imports is for exports to developed markets rather than used internally. For example, one estimate is that around 60 percent of imports are used, directly and indirectly, for exports, less than 15 percent for consumption, and some 20–25 percent for investment (Akyuz, 2010). *Thus, the Chinese economy plays an important role in importing for exports and for export-oriented investment, but much less for domestic consumption*.

A slowing of Chinese exports to the US and the EU and a more balanced growth between exports and domestic consumption are likely to have a strong impact on the region's economies by slowing imports of parts and components (as well as commodities). *For China to become a regional growth locomotive, it would need to raise not only its domestic consumption as a proportion of GDP but also its import content and, in particular, its imports of final (manufactured) goods from the region.*

4.5. Conclusions and Implications

Prospects for world economic conditions over the medium and longer term look uncertain, as the global economy adjusts to slower growth and a more volatile economic environment. The extraordinary performance of ASEAN and East Asia, particularly China, before the Global Financial Crisis of 2008, seems to have been driven to a large extent by exceptional global conditions that are unlikely to repeat in coming years. It is not clear to what extent the region's economies can sustain a reasonable pace of growth in the face of protracted instability and weakness in developed economies, particularly the EU, because of a slower trade and investment environment, including as a result of tighter global financial conditions.

In Southeast and East Asia, regional growth prospects have been linked significantly to China. However, its economy will have to go through a major adjustment, or rebalancing. In the process, China is unlikely to maintain its past strong growth; and the related impact on imports from the region (both manufactures and commodities) is at best unclear, but most likely will mean slowing demand. At the same time, the high-performing ASEAN economies, e.g., Thailand and Malaysia, seem to be caught in a middle-income trap, facing competition from below, without as yet being able to upgrade to join East Asian economies (e.g., Korea, Taiwan).[5]

[5] See Abonyi (2013).

Over the longer term, ASEAN and China (along with India) will indeed provide growing and diversifying markets for the region's firms, including SMEs. Disposable incomes in the region will rise appreciably, though continuing to lag developed economies significantly for the foreseeable future. The focus of global competition will, therefore, shift over time from production to serve consumers in developed economy markets, to supplying consumers in the region's economies.

The *implications* of the above for internationalization of SMEs are as follows:

- (1) Developed economies, in particular, the US and the EU, are likely to remain key markets for ASEAN's and East Asia's manufactured exports in coming years; and although buying behavior is likely to be more cautious and changing, consumers in these markets will continue to have substantially higher disposable incomes than consumers in Asian emerging markets. In this context, the ASEAN and East Asia region is likely to retain its present characteristic of significant intra-regional manufactures trade in parts and components, for final products aimed primarily at (albeit slowing) developed markets, mostly outside the region. *This implies the need for SME internationalization to continue to focus on participating and/or upgrading capabilities within the framework of GVCs and related production networks. This will also remain relevant as the focus of production shifts increasingly to ASEAN and East Asia final markets, within the framework of regional value chains and related production networks.*

- (2) Asian emerging markets (i.e., ASEAN, China, and India) present significant growth opportunities over the longer term. *This will present growing opportunities for existing final products and services by the region's SMEs.* However, consumers in these markets will continue to have significantly lower incomes and face constraints different from those in developed economies (e.g., large rural populations, fragmented markets, significant income inequality). *This implies the need in the internationalization of region's SMEs to think beyond simply exporting, and to strengthen their capacity for innovation of new types of products, services, and business models to serve markets and consumers whose characteristics and buying patterns are likely to be substantially different from the region's traditional final markets and consumers in developed economies.*

5. Best Policy Practices for SME Internationalization for ASEAN and East Asia

5.1. Framework for Internationalization

As discussed in Section 2.2., SMEs can internationalize for ASEAN and East Asian markets on three tracks: (1) *exporting existing products/services (B-C);* (2) *suppliers in GVCs and related production networks (B-B);* and (3) *innovating for Asian emerging markets*. While these are quite distinct in terms of their implications for enterprise strategies and related capabilities, a given firm, in principle, can follow more than one strategy. For example, an enterprise can export existing products to ASEAN markets, while also innovating new products.

In general, SME internationalization on all three tracks faces similar basic barriers (Section 3), though potentially differing in their relative importance. For example, all SMEs need to understand relevant rules and regulations in regional markets, as well as related customer characteristics, needs, and constraints. However, a firm exporting existing products is looking to ensure that its products match existing customer needs, and is likely to focus more on issues such as marketing and distribution channels. A firm innovating a new product, on the other hand, has to invest initially much more in exploring and understanding potential customer needs and related constraints as the basis for new product development.

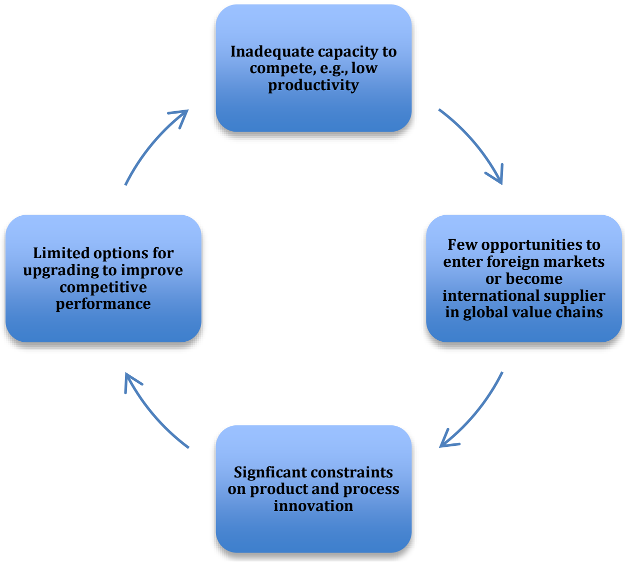
Policy practices to support internationalization should, in general, respond to the key barriers identified, and be consistent with the emerging characteristics of an evolving ASEAN and East Asia regional market. It is useful to begin with a framework identifying the general stages of SME internationalization (introduced briefly in Section 3), as the basis for organizing policy measures and identifying best practice. The stages of internationalization (Figure 2.12) are as follows: (1) *preparation* involves pre-internationalization, getting ready for entering foreign markets directly or as a supplier; (2) *active engagement* is the start or early implementation of internationalization activities; and (3) *growth and expansion* involves strengthening and enlarging the product market position of the firm.

Figure 2.12: Stages of Internationalization

Source: Adapted and modified from Spring Singapore (2011).

A key basic factor conditioning internationalization relates to the competitiveness of SMEs. This paper is not intended to address this broad issue directly. However, the link between competitiveness and internationalization has to be recognized: SMEs that 'go international' are entering into a significantly more competitive product market environment, with corresponding implications for the need to strengthen the capabilities of firms, in part the necessary focus of best policy practices (Figure 2.13).

Figure 2.13: Constraining Link between Competitiveness and Internationalization



Source: Adapted and modified from UNECLAC (2013).

It is useful to define what is meant by '*best policy practice*' in this paper in terms of the examples that follow. It should have the following characteristics:

- Recognized as important to SME internationalization capabilities and/or performance, by both firms and government policy makers;
- Feasible to implement in a wide range of settings, e.g., diverse economies, industries, and firms;
- Effective in bringing about expected outcomes; and
- Efficient in terms of institutional capacity, e.g., to administer and monitor, and with respect to resource use.

5.2. Examples of Best Policy Practices

It is useful to recognize two different overall (ideal) strategies in approaching policies towards SME internationalization.

- *Bottom-up approach:* This is the German Mittelstand strategy that builds on business associations, craft guilds, and academic institutions working with the German government to facilitate SME internationalization, e.g., related to management skills, technology, and innovation. It is these institutions that take the leading role in working with firms. Government facilitates the process by providing a supportive environment, e.g., through tax incentives, streamlining rules and procedures, supporting innovation, and seed funding.

- *Top-down approach:* This is the strategy adopted in most ASEAN and East Asian economies, such as Singapore, Malaysia, and Korea. It uses concepts such as an 'SME Master Plan', and creation of a central SME agency responsible for planning, coordinating, and approving SME-related efforts. At the same time, the importance of industry/value chain–level associations is recognized to varying extent in most Asian economies.

In terms of best practice at the overall level, an effective SME internationalization strategy ideally combines both approaches. For example, government can support a bottom-up approach that is sector led, and gives a key role to industry and cluster associations (e.g., Thailand's automotive sector strategy). At the same time, government can provide effective guidance through a top-down, coordinated, and integrated strategy and related programmes for internationalization that have the support and ownership of the business and academic communities (e.g., Malaysia's rubber manufacturing sector strategy).

A number of recent studies have surveyed existing policy measures supporting SME internationalization in order to identify those that have been most effective ('best practice'). Of particular relevance here are (1) APEC (2013), which looked at 13 economies[6]; (2) SPRINT Singapore (2011), which involved an assessment of 8 economies, largely overlapping with the APEC study, but from a different perspective[7]; (3) OECD (2013), which covered governments and SMEs in OECD countries, with particular emphasis on SME internationalization related to what are termed as 'high growth markets', including in East Asia and ASEAN; and (4) European Commission (2011), a survey of SME internationalization programmes in the EU countries, but focusing on target markets outside the EU. It is useful to summarize the key results of these studies, as together they tend to identify what are presently seen as 'best policy practices' for SME internationalization, and there was significant overlap among the results of the surveys in identifying best policy practices.

[6] APEC (2013) included Australia (8), Canada (6), Taiwan (4), Hong Kong (5), Indonesia (5), Japan (1), Malaysia (4), New Zealand (8), Philippines (1), Singapore (4), Thailand (1), and Viet Nam (1).

[7] Australia, Hong Kong, Japan, Malaysia, Peru, Singapore, Taiwan, and the US.

In general, the emphasis of policy measures is mostly on the *preparation* stage, helping firms get ready for internationalization, with information, financing, and training. There is generally less focus on the *active engagement* and even less on the *growth and expansion* stages. Also, in many cases governments work with industry associations and private sector experts in the preparation and delivery of key policy initiatives, e.g., trade fairs and missions, and market-related information. In general, the focus of best policy practices includes the following:

- One of the two leading areas of policy focus involves filling gaps in *information* about overseas markets, and related administrative requirements for market entry. This often takes the form of informing or promoting general industry–wide business opportunities, which are generally seen as less effective than more tailored and targeted workshops

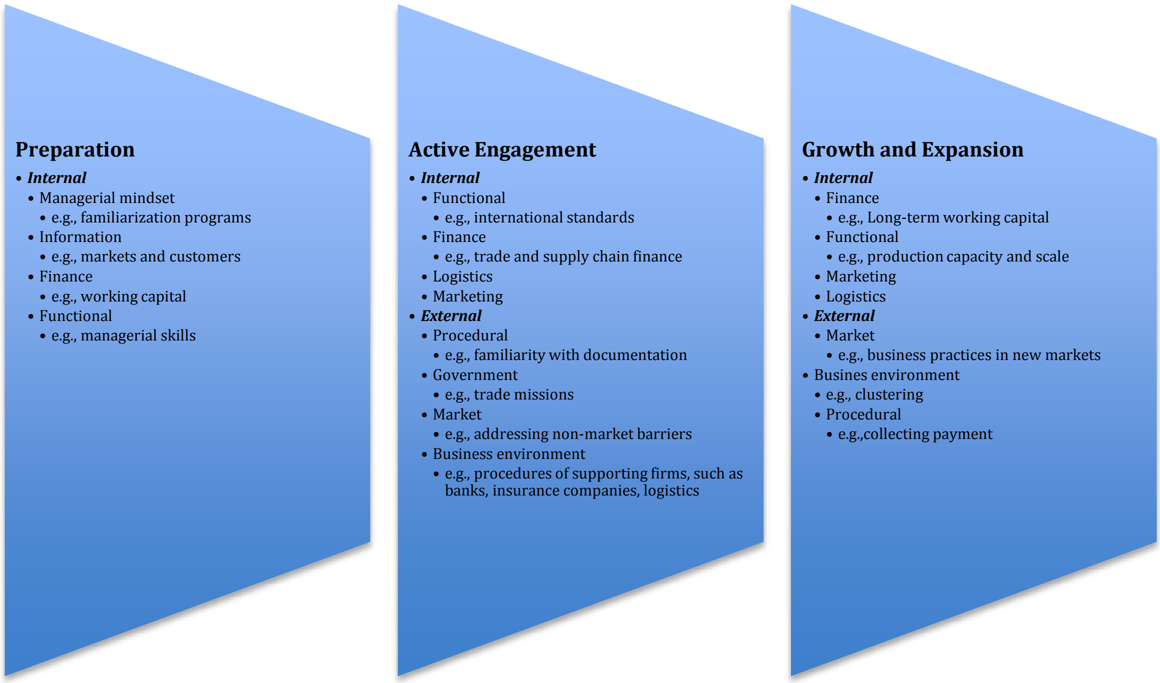
- This, in turn, leads to an emphasis on overseas *missions and exhibitions*, to familiarize firms with international market trends, particular foreign markets, and to showcase SME products. Related to this is a relatively widespread assistance for *training* on ‘doing business’ internationally, including support for visits to, and training in, foreign markets.

- The second major area of policy emphasis and practice relates to *finance* (e.g., general credit, export credit, insurance, risk management, and venture capital); and a wide variety of programmes exist involving a range of financing mechanisms and related support.

- Next most common purpose of the initiatives reported is *development of SME owners' business skills*, including both general business skills with relevance to internationalization (e.g., business plans, financial management) and more specifically relevant skills, such as obtaining/using market intelligence.

- Facilitating SMEs *to form strategic alliances, networks, and clusters at home and/or in export markets*, including in the context of GVCs, also received significant attention, e.g., supporting missions and exhibitions to link SMEs to multinational corporations, some focus on establishing innovation centres and ‘supplier precincts’. However, the programmes involved seem to have had uneven results to date, and therefore the implications for ‘best practice’ are less clear.

Figure 2.14: Stages of Internationalization and Examples of Policy Areas



Source: Adapted and modified from Spring Singapore 2011.

A summary of the areas of best policy practices for SME internationalization is presented in the policy matrix in the appendix. A number of specific examples are presented here, reflecting the focus and nature of best practice.[8]

Preparation Stage

Finance

Providing adequate working capital

- Internationalization, whether entering foreign markets or as suppliers in GVCs, requires adequate working capital for short-term obligations that burn quickly through cash resources, such as inventory or promotion (advertising). Generally, small businesses are cash poor, requiring sufficient and ready access to financing, which is generally challenging in the region's collateral-based banking systems. Such access has also become even more difficult following the 2008 Global Financial Crisis, with a significant weakening of capital flows to Asia from the US and especially from the EU (Section 4). Governments generally recognize the financing challenge to SMEs, particularly after

[8] The Spring Singapore (2011) study took a particularly thorough approach to identifying best policy practices for SME internationalization, and its results are also consistent with more general findings of other studies. Therefore, it serves as an especially good reference point for this section.

the crisis, and a wide range of policy measures and programmes are aimed at providing working capital support.

- Examples include (1) Hong Kong's SME Loan Guarantee Scheme , provided by the Trade and Industry Department , aimed at helping individual SMEs secure loans with the government acting as the guarantor. (2) Japan's Overseas Investment Loans, provided by the Japan Finance Corporation and the Japan Bank for International Cooperation, to provide financing for projects undertaken in developing countries in which Japanese firms have equity shares.

Risk sharing to facilitate bank borrowing and financing

- Financial institutions that are generally careful in lending to SMEs under the best of conditions are particularly sensitive to the risks involved, and reluctant to lend to small businesses in uncertain overseas ventures, especially for start-up ventures. Government measures aimed to share the risk, e.g., of default, provide needed assurance to reduce the perceived risk of lending to SMEs for international operations, especially for early-stage financing. A related mechanism to facilitate such lending involves government assistance to share part of the cost of loan insurance premiums.
- Examples include (1) Singapore's Internationalization Finance Scheme, administered by International Enteprise (IE) Singapore, aimed at assisting Singapore-based companies to enter international markets by providing financing for fixed assets, as well as for the working capital expenses of overseas projects. (2) Taiwan's Globalsure Credit Insurance, provided by the Export-Import Bank, is particularly interesting and important to SMEs, aimed at covering payment risk related to the delivery of goods and services, and insuring a company's accounts receivables from losses due to insolvency. (3) Singapore's SPRING Start-up Enterprise Development Scheme involves government partnership with the private sector to provide equity-based co-financing for Singapore-based start-ups with innovative products or processes with strong potential on international markets.

Information/Functional

Internationalization workshops

- Government and business recognize information gaps and training related to internationalization skills as key constraints on SME internationalization. In general, experience suggests that targeted workshops that provide both information and advice for firms, in particular value chains, are more effective than general seminars on internationalization issues.

- Examples include the following: (1) Malaysia's Development Program for New Exporters, administered by the Malaysia External Trade Development Corporation, is a 3-year programme that provides firms with advice, information, and assistance, and includes visits, for selected markets. (2) Japan's Globalization Workshop, administered by the Organisation for Small & Medium Enterprises and Regional Innovation Japan, provides experts and managers of SMEs with experience in overseas markets in seminars on the globalization of SMEs that give advice on concrete steps on how to develop business in overseas markets. (3) Hong Kong's Pro-Act Training and Development Centre (Global Business) provides general training in areas such as import/export and shipping document, and merchandising training for international markets; and also specific training programmes related to internationalization under the Skills Upgrading Scheme.

Functional

Market familiarization through immersion training

- Hands-on experience in foreign markets is recognized as particularly useful for effective internationalization. Structured overseas training programmes for employees can provide needed practical understanding of foreign markets; and can have a great impact, particularly when combined with using returning staff in the development of firm-wide training programmes. Although the benefits of such programmes are significant, so is the cost to the firm. Therefore, government assistance in their development and cost (sharing) is seen as particularly useful and important.
- Examples include (1) Singapore's Manpower and International Business Fellowship , by IE Singapore, supports companies in training executives and networking in selected markets through both full-time postgraduate study, and tailored short-term (maximum 10 days) senior executive programmes. (2) Japan's International Federation Training Project, by the National Federation of Small Business Association, arranges overseas study tours for young owners and selected employees of SMEs.

Skill development for suppliers in GVCs

- Effective initial entry and sustained participation in GVCs requires raising and maintaining SME technical and managerial skills. Without the necessary skill levels small firms will not be considered as potential suppliers by large and international firms and buyers. At the same time, participation in GVCs can further accelerate SMEs' upgrading of skills through technology and knowledge transfer, and learning of new business practices. Therefore, policies and related institutions aimed at raising the technical and managerial skills of SMEs are essential for their participation in GVCs. However, public training institutions are often not sufficiently responsive to skill upgrading requirements of SMEs (UNCTAD, 2010).

- Examples of effective programmes and institutions include (1) Malaysia's Penang Skills Development Centre, an industry-led tripartite skills training and education centre, a partnership of industry, government, and academia, that provides training and education programmes and internships to support operational requirements and to keep up-to-date on technological progress to make SMEs 'partnership ready', with a focus on the electronics/IT sector. (2) South African government's re-launched sectoral training authorities aimed at accrediting training providers and their curricula, to ensure adequate quality; financed in part through employer contributions, in order to create a market-friendly and responsive mechanism.

Active Engagement Stage

Procedural

Assistance with Regulatory and Standards Requirements

- Complex and costly regulatory requirements of international markets, involving, for example, legal and business registration, are significant challenges to small firms. Meeting different standards, testing, and conformity assessment procedures can be especially difficult. These barriers increase the cost, time, and uncertainty of market entry; and inability to meet required standards may prevent entry. Government support related to these functions is particularly important for small firms.
- Examples include (1) Hong Kong's Comply with Global Sourcing Buyers' Requirements on Green and Ethical Procurement, by the Hong Kong Trade Development Centre, is a value-chain and standard-specific programme of assistance to SMEs in the electronics and electrical industry to comply with Global Sourcing Buyers' Requirements on Green and Ethical Procurement. (2) Singapore's REACH Registration Assistance Pilot Scheme, by Spring Singapore, helps firms comply with the EU's REACH regulation (Registration, Evaluation, Authorization, and Restriction of Chemicals) by providing support for consultancy assistance. (3) Singapore's Expert Technical Assistance Center supports understanding and compliance with standards and technical regulations for food and electrical/electronic

exports. (4) Regional (EU) initiative in China:[9] Established in 2010, the EU SME Centre in Beijing, China, supports SMEs that want to export to, or invest in, China. SMEs generally do not have the capability or resources to deal with the complex Chinese administrative, legal, and regulatory environment, particularly at the early market entry stage. The EU Centre offers a wide range of services related to market information, technical standards, procedures, as well as training programmes and other services. Similar centres have been established in India (2008) and for ASEAN (in Thailand, in 2011).

Functional (Internal)/Market (External)

Building linkages and alliances

- Building alliances allows SMEs to leverage their capabilities through partnerships to achieve economies of scale and compete more efficiently (e.g., lower costs) and effectively (e.g., greater access to international buyers). Building relationships with international buyers, directly or through alliances, allows SMEs to link to key GVCs. Initiatives aimed at supporting SMEs in building such linkages and alliances are particularly important in the context of the region's manufacturing experience, given its central role in GVCs and related regional production networks in key industries, e.g., electronics, automotive, garments.
- Examples include (1) Japan's Business Alliance for Promoting SMEs, through the Ministry of Economy, Trade and Industry (METI), promotes and supports business alliances between Japan and Taiwan in the form of joint ventures, technology partnerships, and supplier arrangements. (2) Singapore's International Partners Programme, by IE Singapore, facilitates and supports international alliances for Singapore-based firms, particularly in the 'go-to-market' or the *active engagement* stage, including the preparation of business plans, and resources and management support for implementation. (3) Singapore Business Federation Global Sourcing Hub is an online business portal that provides instant automated access to global sourcing opportunities. (4) Australia's Industry Innovation Precincts are intended to facilitate connection of firms to global supply chains by developing an agglomeration of competitive firms and research institutions in a specific geographic area.

[9] OECD (2013).

Growth and Expansion Stage

Functional (Internal)/Market (External)

Strengthening capacity for compliance with international standards

- An essential requirement for participation in GVCs is the ability of firms to meet a variety of stringent product and process standards (e.g., quality). At the same time, strengthening the capacity to meet such standards for SMEs already serving international markets, either directly (exporting) or as suppliers in GVCs, is a key requirement for their growth and expansion (e.g., UNCTAD, 2010). It allows firms to enter new markets; and/or upgrade and therefore expand as suppliers in particular value chains.
- Example: An effective private sector initiative is IBM's PartnerWorld programme in Viet Nam, a comprehensive upgrading and marketing programme for IBM business partners and suppliers, focused on strengthening their capacity to provide required products and services. It involves three different types of support, depending on the level of investment by supplier firms, e.g., 'Member', involving a minimum level of commitment; 'Advanced', for firms that have made significant investments in their business relationship with IBM; and 'Premier', for firms that have made very significant investments in IBM-related products, technologies, and skill development.

Business environment

Clustering and related networks

- As discussed, enterprise clusters and related networks—involving focused cooperation among SMEs, and between SMEs and larger firms (domestic and foreign), and other supporting institutions (e.g., government agencies, research and educational institutions)—can increase productivity and efficiency; help in the commercialization of ideas and in new business formation; and stimulate and enable product market innovation. It also makes participating SMEs more attractive as potential suppliers to larger and international firms and buyers. Clustering has received a great deal of attention given their importance. However, building and sustaining viable enterprise clusters remains a challenge. Two factors have emerged as particularly important: (1) the role of industry/value chain-level institutions; and (2) the essential need for clusters to be anchored in clear and credible business/commercial rationale, i.e., they generally cannot be 'willed' into being by governments alone.

- Example: (1) Penang's (Malaysia) electronics/IT cluster is a particularly successful example of cluster development and maintenance. It also illustrates the central role of cluster-related institutions, including the Penang Development Corporation providing general industry-level support, and the Penang Skills Development Centre's critical role related to skill development and upgrading. (2) Thailand's hard disc drive (HDD) cluster is a useful example of both success and constraints in cluster development. Thailand is the largest exporter of hard disk drives in the world. A key to the clusters growth and expansion was the creation in 2005 of the Hard Disk Drive Institute (HDDI), following a government-financed but industry-driven sector study. HDDI is private sector driven, involving the leading global HDD producers, local research institutes, and government organizations such as the Board of Investment, focusing on helping to strengthen the capabilities of domestic suppliers. However, while the HDD cluster has been very successful in expanding sales, it has been less successful in Thai firms upgrading to higher value activities. (3) South Africa's Durban Auto Cluster has been identified by Toyota and its suppliers as very effective in strengthening supplier capacity and facilitating inter-firm collaboration, linked in part to a parallel initiative, the Benchmarking Club. Some firms noted the key role these initiatives played in their capacity to survive and grow (UNCTAD, 2010). Activities include specialist skills development in engineering and production management, as well as in product development. It should be noted that most firms also belonged to at least another industry association such as the National Association of Automotive Component and Allied Manufacturers and the Steel and Engineering Industry Federation of South Africa.

6. Next Steps: Doing Different Things and Doing Things Differently

6.1. Gaps in Best Policy Practices

A number of gaps in best policy practices have been identified, e.g., in studies noted, particularly from the perspective of SMEs surveyed. These include (1) user-friendly online channels for market information, including information on the business impact of free trade areas/agreements and regional integration (e.g., AEC); (2) measures to help defray the initial costs at the *active engagement stage*, e.g., cost of setting up and running an overseas representative office; (3) support for what can be extensive long-term operational costs at the *growth and expansion stage*, particularly important with respect to the long-term success and sustainability of SMEs' international operations facing significant potential risks and market uncertainty; and (4) supply-chain related assistance with respect to logistics (and transportation) for new markets, oriented to specific businesses, including for suppliers of such services.

Beyond the above, three gaps in best practice are particularly important in the context of a changing regional economy. These are (1) trade and supply chain finance, (2) integrating SMEs more effectively into GVCs, and (3) moving from exporting to innovating for ASEAN and (emerging) East Asian markets.

6.1.1. Trade and supply chain finance[10]

Financing needs of SMEs are identified as one of the two key areas for policy attention for internationalization. However, access to adequate trade and supply chain finance, which relate specifically to international operations, get relatively less attention. *Trade finance* includes loans and guarantees for imports and exports; with guarantees often in the form of letters of credit, which shift an exporter's payment risk to the bank; and various other forms of risk coverage such as currency and interest rate risk. *Supply chain finance* is a form of receivables finance or factoring. For example, the SME supplier sends an invoice to a (larger) buyer, who approves it in a supply chain finance platform, on an irrevocable basis, allowing the supplier to sell the invoice (i.e., asset-based finance) to a financial institution.

The Global Economic Crisis (2008) greatly worsened the problem of trade and supply chain finance by reducing the general availability of credit, including for traditional working capital, and therefore spurring greater interest in risk-mitigating financial instruments such as trade finance. Banks in ASEAN (e.g., Malaysia and Thailand) and East Asia (e.g., Korea) were also affected, including by a shortage of the dollars needed for trade. In Asian emerging economies, weak banking systems, lack of transparency, and more stringent Basel money-laundering regulations and 'know your client requirements' further constrain the general availability of trade finance. SMEs have had particular difficulty securing guarantees for payment obligations from banks (e.g., letters of credit).

As an example, in 2011, banks in Asian developing countries received requests for trade finance totalling $2.1 trillion, of which $425 billion were

[10] ADB–OECD (2014).

rejected (ADB–OECD, 2014). An ADB survey of 500 firms makes clear the implications of the trade finance gap: a 10 percent increase in trade finance would lead to a 5 percent increase in production and staffing by firms. A survey of SMEs in the EU showed that half of the firms considered trade finance essential to enter new international markets.[11] Risk coverage, such as currency risk (forward exchange, currency options, etc.) and rate risk (swaps), is used by 75 percent of international (EU) SMEs for international cash management (e-banking, cash pooling).

The problem is particularly acute for SMEs supplying larger firms within the framework of GVCs. Therefore, greater attention to supply chain finance can play an important role in facilitating the internationalization of SMEs; with significant potential benefits for buyers, suppliers, and lenders:

- For (larger) buyers, it reduces working capital requirements by stretching out payment terms to suppliers, strengthens the relationship with suppliers by allowing for timely payments, and helps secure delivery of supplies.
- . For (SME) suppliers, it allows for early payment of invoices; reduces working capital requirements by reducing outstanding payables; leads to more predictable payment flows and, therefore, easier cash management; strengthens relationship with buyers; and reduces the cost of financing.
- For lenders, it leads to increased buyer financing with greater returns, efficient transparency and visibility of underlying payables, and builds stronger relationships with buyers and their suppliers.

Supply chain finance provides an opportunity for supporting firms not traditionally considered as bankable, by addressing two key constraints on SME financing: poor financial position and lack of collateral. Unlike traditional financing, such as for working capital, that focuses on SMEs' financial position and available collateral, supply chain finance focuses on the strength and longevity of a supply chain, and the longer-term mutual dependence of buyer and supplier. However, whereas trade finance places the risk on the bank, in supply chain finance it is corporate risk.

Effective policy measures to support trade and supply chain finance would greatly facilitate SME internationalization. It would expand opportunities for small firms to enter international markets, and would support SME participation as suppliers in GVCs.

[11] Roland Berger Strategy Consultant (2013)

6.1.2. Integrating SMEs into Global Value Chains[12]

Participation in GVCs is a key means for SMEs to internationalize as suppliers providing intermediate inputs, usually as subcontractors several levels down from the ultimate buyer or lead firm, e.g., global brands such as Apple or Levi. Around 80 percent of world trade is now through GVCs (UNCTAD, 2013). The benefits of SMEs integrating into GVCs include strengthening the technical and managerial capabilities of firms, increasing capacity utilization and production efficiency, strengthening the reputation and credibility of the firm, and providing a manageable way for SMEs to reach and compete in global markets. Participation in GVCs also places great demands on small firms that may be briefly summarized as the requirement to deliver the right product (product standards), in the right quantity (production capacity), with the right quality (quality standards), at the right time (efficient logistics), and produced in the right way (process standards). These are significant challenges for SMEs.

There are clear indications that governments' support for SME participation in GVCs has been limited in their effectiveness (e.g., APEC, 2014; OECD, 2008). This also reflects the inadequate understanding by SMEs of the global economic environment, including the nature of GVCs and related production networks, and their implications for needed policy initiatives to support SME participation. For example, in a comprehensive OECD study (OECD, 2008) SMEs interviewed did not mention skill development programmes, a critical requirement for successful participation in GVCs. Furthermore, since the Global Economic Crisis of 2008, GVCs have undergone structural changes, with important implications for SME suppliers and needed policy support:

- *Consolidation*: Lead firms have generally reduced the number of their first-tier suppliers. This makes it more difficult for new suppliers to participate within the framework of GVCs and related networks.
- *Convergence*: As synergies develop among different value chains, lead firms in different sectors are increasingly sourcing from the same suppliers, e.g., Foxconn (HonHai) supplies firms in the mobile phone (e.g., Apple), computer (e.g., Acer), and information (e.g., Cisco) sectors.
- *Re-shoring*: There seems to have been some movement by lead firms to some extent to reshore some of their operations partly because of cost, and also risk; contributing to many Asian SMEs reporting significant declines in order (e.g., Rosey, *et al.*, 2009). However, the extent is not clear.

[12] Key reference: APEC (2014).

- *Developing economies becoming major consumer markets*: As discussed in Section 4, Asian emerging markets' relative share of global consumption is growing, with implications for the future focus of GVCs.
- *Trade in services is becoming more important*: Tradable services are moving well beyond business process outsourcing to more advanced and higher value-added knowledge-based services such as research and development (R&D) and design, which in turn are closely linked to the production process.
- *Rise of e-commerce and Information and Communications Technology (ICT) technologies*: The development of internet-based business-related activities has moved into areas such as e-procurement and e-logistics, allowing closer integration of geographically dispersed activities, and expanding access to markets and buyers. This makes it easier for dispersed and relatively isolated SMEs to participate in GVCs, including through improved access to information on markets and potential partners/suppliers/customers, and greater marketing and distribution skills. At the same time, it requires for SMEs to invest in IT-related capabilities.

In considering SMEs as suppliers, large firms (e.g., multinational enterprises) assess them on a variety of criteria, including hard and soft strengths. Hard strengths involve attributes such as product quality, product price, and timely delivery. Soft strengths cover issues such as financial soundness of the firm, production capacity, flexibility, geographic location, capacity to meet standards and certification, ICT level of business operations, and capacity for product and process innovation.

Globalization affects different sectors in different ways, and therefore the role of SMEs and their challenges vary across sectors/GVCs (APEC, 2014). For example:

- In the *food processing GVC,* the key issue for SMEs is to meet a wide variety of international, industrial, region-specific, and firm-specific product and process standards.
- In the *automotive value GVC,* it is not clear to what extent the shift of car production and sales in emerging markets is translating into supplier opportunities for regional SMEs because of geographic expansion, consolidation, and cost reduction measures of the first tier mega-suppliers, particularly following the Global Economic Crisis of 2008; and because of the constraints faced by small auto-parts suppliers, particularly access to capital.

- In the *electronics GVC,* white-label products (e.g., refrigerators, washers, and dryers) provide opportunities for SME new entrants, particularly from less developed economies, as they compete on the basis of price, and require lower-level skills. The longer-term challenge is to strengthen technical skills of enterprises to move up the value chain to more value-added activities in order to protect (ideally to expand) their competitive supplier position, and to add value. At the same time, opportunities are also growing for SMEs to provide related services, e.g., applications (apps) for smartphones.
- The *handicraft GVC* is expanding strongly both in terms of product mix and geographic coverage, partly as a result of growing e-commerce, with SMEs in Asian emerging economies as major producers. This is in part because of low entry requirements in this value chain, such as low start-up capital and flexible working time and location.

Given the evolving nature of GVCs, and their great diversity, it is difficult to have a set of general policy measures to support SME supplier participation. It requires working at two levels: (1) general or horizontal level and (2) industry or GVC level.

- At the *general level*, SMEs often have limited understanding of the structure and dynamics of GVCs and their role in the global economy, though differing in specifics among sectors/GVCs. This suggests the need for programmes to promote awareness and understanding of the general benefits and opportunities of linking SMEs to GVCs, and to work with large or lead enterprises (e.g., multinational corporations) to develop specific capacity building programmes for local SMEs. An example of such a general initiative at the regional level is the APEC SME Innovation Center established in Korea in 2006, which has provided advice to 96 firms in 7 economies. Strengthening support for supply chain financing is another example of addressing the general and severe financing constraint on SMEs, specifically in the context of GVC participation. Similarly, policy measures to strengthen the capacity of SMEs related to ICT are increasingly vital for participation in various GVCs. A general commitment to supporting SMEs to meet international standards and certification (e.g., ISOs) is also essential.

- At the *industry level*, the basic requirement is for policymakers to understand the structure and dynamics of particular GVCs, and how they may be linked to the domestic economy and integrate local firms. Similarly, most SMEs across different industries are not able to identify their competitive strengths and constraints within their own value chain (e.g., APEC, 2014; OECD, 2008). Policy initiatives, therefore, have to be developed to support the particular requirements of SME participation in specific GVCs, as discussed (as in the case of the Penang electronics/IT cluster). This can include providing access to market-related information for specific GVCs through value chain specific trade fairs, online platforms, and advisory centres. Facilitating the formation and operation of enterprise clusters in specific GVCs can expand production capacity and accelerate innovation. Beyond a general focus on strengthening SME capacity for meeting standards and certification, policy measures can focus on training related to standards and certification in particular GVCs, in partnership with industry associations (as in the example of the effective Penang Skills Development Centre).

6.1.3. From Exporting to Innovating for Asian Emerging Markets[13]

As the global economy adjusts and developed economies continue with slow growth, Asian emerging markets present increasing opportunities for the region's SMEs. A key challenge is to move beyond exporting to innovating for these markets. Internationalizing SMEs must become more skilled at introducing—innovating—new and improved products and services, production processes, and business models suited to changing regional and international markets. Therefore, strengthening the innovation-related capabilities of the region's SMEs will be important for success in ASEAN and (emerging) East Asia markets.

Consumers in Asian emerging markets have high aspirations, but relatively low incomes, and a variety of constraints not usually found in developed economies, such as fragmented markets and high rural populations (Section 4). This provides the basis for a broad concept of innovation more appropriate to these markets, involving a wider range of innovation-related capabilities more accessible to SMEs, beyond high levels of scientific and technological knowledge, and related R&D. Innovation includes creating new products and production processes; adapting existing technologies to local user needs and constraints; and developing new types of marketing and distribution channels, services, and business models appropriate to consumers and conditions in the Asian emerging markets. In these markets, interaction with potential users/consumers at the early stages of product development is particularly important in providing insights on the potential use of a product or service, and required adaptations for successful commercialization to specific consumer needs and constraints. Investing in sales, marketing, and support

[13] Based on Abonyi (2013), which develops this issue in the context of Thailand.

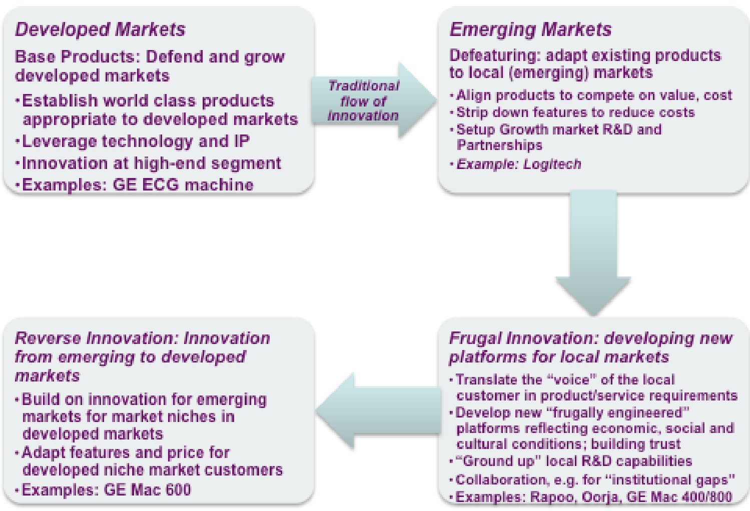
activities are also essential in realizing the value of innovations in reaching consumers in the fragmented and rural markets of the region. This can lead not only to innovations for emerging markets, termed ‘frugal innovation’, but also to the potential for scaling up to global niche markets, or ‘reverse innovation’. Examples include the following:

- ***Product innovation (frugal innovation).*** *Rapoo (China) computer mouse* is an illustration of the concept of frugal innovation: it taught Logitech an important lesson about exporting to Asian emerging markets. Logitech is a leading global supplier of personal computer (PC) accessories, headquartered in Switzerland. Looking to leverage its global brand and competitive advantage, it introduced a PC mouse in China priced at US$50. This product, following traditional strategy, was a stripped down version of a mouse originally designed for developed markets, and met very limited success in China. In addition to its high price, the Logitech mouse was not responsive to Chinese consumers’ particular needs and constraints. These did not lag needs in developed economies, but were quite distinct and required a different approach. For example, the Rapoo mouse had a much greater range than Logitech’s product in order to be used as remote control for TVs. These serve as the central entertainment device in a Chinese household, but with content downloaded from the Internet given constraints on TV coverage and cost. Given the distance involved, the Rapoo mouse was also designed to shield from frequent interference from other electronic devices (e.g., household appliances, phones), an issue in small Chinese homes. And priced at $15, it was far more affordable.

- ***Product and business model innovation (frugal innovation).*** India’s Pune-based *First Energy’s Oorja stove*, selected by the World Economic Forum as ‘Technology Pioneer 2012’, is a low-smoke, low-cost, efficient stove, powered by rechargeable batteries, that works on pellets—an organic biofuel made of processed agricultural waste, such as peanut shells and bagasse. It was developed initially for rural Indian women. First Energy is innovating more than a product; in partnering with two non-governmental organizations (NGOs) to reach rural customers and involving local women entrepreneurs to demonstrate and sell the product, it has developed an effective and wide rural distribution network, building essential consumer confidence through association with locally trusted people and organizations. First Energy then introduced larger stoves aimed at the urban commercial market such as hotels, restaurants, and caterers; it is now looking to expand to other Asian emerging markets, including Bangladesh, Indonesia, Sri Lanka, and Viet Nam.

- ***Reverse innovation:*** *GE's electrocardiogram (ECG)* machines sold in Asia (e.g., China and India) were large and expensive. GE's health care research and development centre and laboratory in Bangalore, India, developed a simplified, inexpensive, small, handheld ECG machine called the Mac 400, oriented to the Indian (and, more generally, emerging) market. It can fit into a small backpack and run on batteries as well as main power source, the multiple buttons on a conventional ECG machine were reduced to just four, and the bulky printer replaced by a small one used in portable ticket machines. The price of the Mac 400 is $800 instead of $2,000 for conventional machines, and the cost of an ECG test is reduced to $1 per patient. Further innovations led to a higher-level product for the Chinese market (Mac 800) priced at $2,000. A modified version of these products then also found a niche market in the US and Europe, as the Mac 600 (at $1,200), for example, in primary care doctors' offices, visiting nurses, rural clinics, and paramedics. Based on the more general relevance of its emerging market innovations, GE launched a global strategic initiative called GE Healthymagination, focusing on 'underserved' or marginal communities.

Figure 2.15: Innovation Strategy for Regional and Global Opportunities



Source: Adapted and modified from Accenture (2012).

The concept of frugal (and reverse) innovation in the context of a changing ASEAN and East Asia region has important implications for best policy practice to support SME innovation. The usual approach to innovation tends to focus on supply-side issues, e.g., scientific and technology education and skills, ICT infrastructure, high-level R&D. There is generally far less emphasis on demand- and user-driven approaches to innovation and related requirements. This is especially important in the context of changing Asian emerging markets, which provide significant, but different opportunities of export-through-innovation, including for SMEs. Strengthening the capacity of SMEs to understand the characteristics of these markets and consumers is especially important. This requires early-stage product-related interactions with potential consumers in key markets and, therefore, investment in a wider base of knowledge and skills related to understanding markets and consumers, particularly in emerging economies. Insights gained through such interactions with potential consumers on their needs and constraints related to the use of a product or service can then shape the design, development or adaptation for successful commercialization. Beyond product development, investment in innovation in marketing and distribution systems is also important to ensure that Asian emerging market consumers are effectively served.

6.2. Implications of Levels of Development

The ASEAN and East Asia region contains economies at very different levels of development. For example, Thailand is a middle-income country, extensively integrated into global and regional markets, including through participation in GVCs. By contrast, Myanmar is one of the least-developed economies. It has been relatively isolated for decades, and is now going through an extensive reform process, including a focus on product market integration with the international economy. In both countries, SMEs make up the vast majority of the enterprises and play a key role as sources of jobs and incomes. Although at very different levels of sophistication and competitiveness, SME internationalization is a policy priority for both, with particular focus on the ASEAN and East Asia region.

In reviewing the challenges and needs of SME internationalization for a country such as Myanmar (similarly, for example, for Cambodia and Lao PDR, and to a lesser extent Viet Nam) and comparing it with Thailand (and similarly, for example, with Malaysia), a number of issues emerge:[14]

- In general, the nature of the challenges of SME internationalization is similar for countries at different levels of development, both for moving into new markets and for integrating as suppliers into GVCs.

[14] Particularly useful references for this section include Abe and Dutta (2014) and Abonyi (2013).

For example, SMEs in Myanmar and Thailand face key barriers such as information, finance, internationalization-related skills, and logistics.

- For economies at a lower level of development such as Myanmar, the requirements for policy measures to respond to these shared challenges are much more demanding, both in terms of the generally much poorer general capabilities of the firms and the more severe resource and capacity constraints of government agencies.
- Furthermore, in a more advanced economy such as Thailand, there is generally more experience among SMEs with internationalization, as the potential basis for learning and experience sharing; and it is relatively easier to access key inputs such as information and financing. It is also easier to link with international buyers, given their wider presence in the economy.
- More fundamentally, the business environment supporting SMEs in a more developed economy such as Thailand is far stronger, both in the 'harder' form of infrastructure and logistics systems, and in the 'softer' form of business-related rules, regulations, agency capabilities, and customs procedures, which are much more aligned with international best practice.
- This is particularly relevant, given the link between competitiveness and internationalization, as SMEs in a less developed economy such as Myanmar generally lag significantly in competitive capabilities and performance, compared with firms in an economy such as Thailand.
- The implication of the above is that a less developed economy such as Myanmar has to invest much more in building the general capabilities of SMEs, and in strengthening the supporting business environment (e.g., infrastructure, logistics, general managerial skills), as a prerequisite for considering internationalization in any form. This paper is focused specifically on internationalization-related issues and, therefore, does not consider issues related to the more general strengthening of SMEs.
    - It may be useful to note, however, that one means for creating the necessary business environment historically in less-developed economies in Asia has been the effective use of special economic zones (SEZs). These provide a special protected environment for investors in the form of infrastructure, and rules and procedures that are intended to compensate for the weaknesses of the more general business environment. Ideally, SEZs allow domestic SMEs to develop relationships with international enterprises, strengthening their competitiveness and linkages to international product markets. There are various examples in less developed economies of ASEAN, e.g., Phnom Penh Special Economic Zone in Cambodia, Savannakhet SEZ in

Lao PDR, and the Thilawa SEZ now in preparation in Myanmar. It is important to note that such SEZs are likely to be successful to the extent they are anchored in clear economic and business rationale, and even more so if they focus on addressing specific constraints of firms in particular value chains, e.g., electronics and agro-industry.[15]

The 'stages of internationalization'" framework provides a potentially useful guide to reflect on the implications of the differences for SME internationalization between less developed economies such as Myanmar and more developed economies such as Thailand. As suggested here, in general, the differences are less in the kind of barriers and types of required policy responses, and more in the formulation of the known policies to make sure they respond to actual needs, and that they are feasible in terms of constraints on implementation e.g., by the relevant agencies and capacities of firms. In the context of the 'stages' framework, it may be possible to go further in considering likely differences and their implications.

Given the relative lagging state of domestic enterprises in less developed economies such as Myanmar, it is likely that far less firms will be involved in, and have knowledge of, international activities of any kind. Therefore, the policy emphasis will need to be on the *preparation stage*. A key challenge and priority is helping SMEs get ready for internationalization, using the various policy measures already noted, e.g., information, financing, and developing enterprise linkages. The needs and measures will be similar, but detailed design and implementation requirements will have to differ to ensure their relevance and effectiveness for domestic SMEs. For example, in the case of information on potential markets and buyers, the use of IT is likely to be less effective in an economy such as Myanmar and Cambodia, in terms of SME capabilities and access, and state of infrastructure development (e.g., power, communications). Therefore, more emphasis is likely to be needed on face-to-face activities, such as workshops, along with printed materials. Support for later stages of internationalization, *active engagement* and *growth and expansion* will become relevant and necessary, as domestic SMEs internationalize more and more.

6.3. Potential for Regional Cooperation

Regional cooperation initiatives can complement and enhance country-specific efforts at internationalization. These can be particularly important to

[15] See, for example, Abonyi and Zola (2014).

less developed economies, given their constraints of resources, experience, and knowledge. The rationale for a regional approach includes the following:

- Economies of scale for resources and activities, e.g., training;
- Leveraging through the sharing of information, knowledge, and experience, e.g., on markets, regulations, business opportunities;
- Strengthening a region-wide culture of partnership and collaboration between government and business;
- Updating and adjusting best policy practices based on region-wide learning;
- Build on the key role and potential of cross-border value chain linkages.

Based on an assessment of the barriers to internationalization and examples of best policy practice, the following measures may be considered for regional cooperation to support SME internationalization.[16]

- *Expand cross-border SME financing mechanisms:* As noted, financing, particularly trade and supply chain finance, is a key constraint on SME internationalization, especially in the wake of the Global Economic Crisis of 2008. Therefore, facilitating the cross-border flows of financing and financial instruments—e.g., credit, credit guarantees, and particularly trade and supply chain finance—is especially important to expand SME internationalization. This could include a focus on regional cooperation related to trade and supply chain finance in the broader context of regional financial sector liberalization and cooperation. An important potential regional initiative is an agency/mechanism for providing SME credit information to reduce credit risks and lower the barriers for SME access to financing, given the information gap between lenders and SMEs. Japan's effective SME rating system, the Credit Risk Database Association that uses both quantitative and qualitative information, is a suggestive example.
- *Expand cross-border and regional workshops and training:* Internationalization workshops, particularly targeted at particular value chains of regional importance, and market immersion programmes could play an important role in providing practical information and knowledge to regional SMEs, given multi-country participation. For example, this could focus on delivering accredited management and technological training leading to regional certification, e.g., along the lines of some training programmes offered by the Asian Productivity Organization. This can also help support the building of cross-border alliances and partnerships among the participants.

[16] Parts of this section draw on APEC (2014), though in modified form.

- *Establish comprehensive, SME user-friendly online information portal:* To respond to the information barrier and allow greater sharing of market and business-related information, a region-wide online SME-oriented portal could play an important role. It could include information on market and industry trends and key issues; business opportunities and related leads; business matching on a region-wide basis; comprehensive listing of the region’s enterprises in key value chains to facilitate identification of potential partners/suppliers/buyers; comprehensive information on rules, regulations, and procedures in the region’s markets; list of internationalization-related advisory services and associated organizations and individuals in the region. The EU’s SME Internationalization Portal provides a useful example. It is a database that lists (semi-) public providers of specialized services (e.g., local chambers of commerce) for companies planning to enter international markets; and links to other EU-backed sources of support and advice, such as the European Commission’s Market Access Database that provides market access information for individual non-EU growth markets.

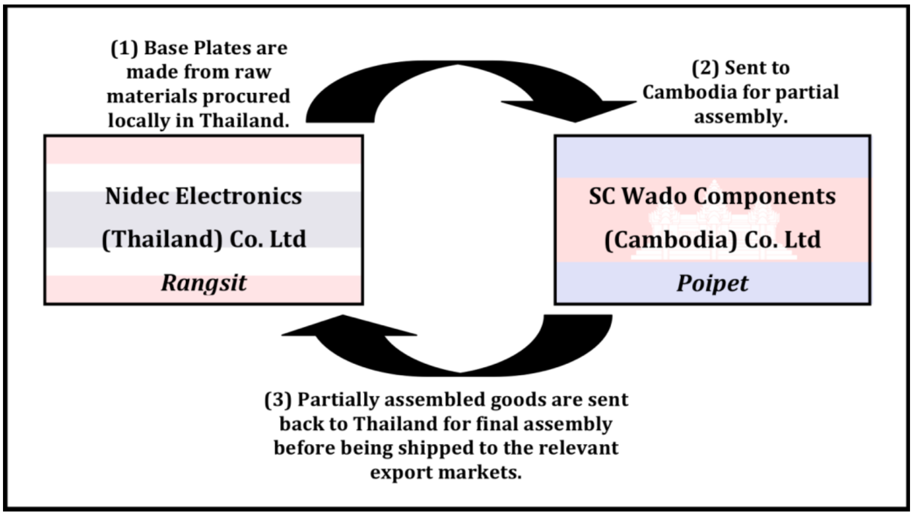
- *Establish AEC SME business centres to support SMEs exporting (directly and indirectly) and investing in the region:* These centres, established in selected locations in the AEC, would provide support and assistance to SMEs for doing business in AEC and East Asian markets. This can include (1) business development services (e.g., focused market information, business and marketing advice, matchmaking support, physical facilities such as desk/secretarial support and meeting rooms); (2) legal services support (e.g., access to practical legal information, referral to service providers such as lawyers and tax advisors); (3) standards and technical issues (e.g., information on required certification, quality, and labeling); and (4) human resources–related support (e.g., access to specialized skills including languages, and referral to training sessions and expertise). The EU business centres, particularly the EU SME Centre in China, could provide useful experience and guidance.

- *Establish a regional ‘SME Internationalization Best Practices Centre’:* There have been many SME internationalization best practices studies, and even more on general SME best practices. An AEC/East Asia best practices centre with easy access and use by firms could serve an important role in supporting SME internationalization. It could provide extensive and practical information to the region’s SMEs on best (and worst) practices, including case studies focusing on specific firms in particular value chains and markets; a practical and supported framework for self-assessment of existing operations; and strategies for firms on adapting and implementing best practices. Ideally, or over time, this could be linked to regional advisory services, such as the suggested AEC SME business centres.

- *SME internationalization through cross-border value chain linkages:* Many of the region's economies are greatly interested in strengthening cross-border economic linkages, particularly involving border areas. Such cross-border linkages in key value chains can contribute to the development of local communities and to product market diversification and upgrading of participating economies and firms, including SMEs. This could be especially effective in linkages between less developed economies, such as Myanmar, and more developed economies, such as Thailand. The garment and textile value chain provides an example, building on the agglomeration of garment and textile SMEs in Mae Sot (Thailand), and a planned industrial zone in Myawaddy (Myanmar) to take advantage of proximity to Thailand.[17] Firms in Myawaddy (e.g., Thai and other Asian investors) can provide low-cost labour for lower value and lower skill activities such as cut/make/trim (CMT), while SMEs in Mae Sot can provide materials and parts for CMT activities and focus on higher value and higher skill activities, such as quality assurance, packaging, and shipping (logistics services). Such cross-border cooperation can provide opportunities for SMEs both in Myanmar and Thailand to 'internationalize', starting in a more limited and manageable way, with neighbouring countries, and expand over time within the framework of GVCs. Recent investment from Thailand to Cambodia provides a general illustration (Figure 2.16), and a mapping of the garment and textile cross-border value chain linkages in the Greater Mekong Subregion (Figure 2.17) provides the context for the Myawaddy–Mae Sot example.

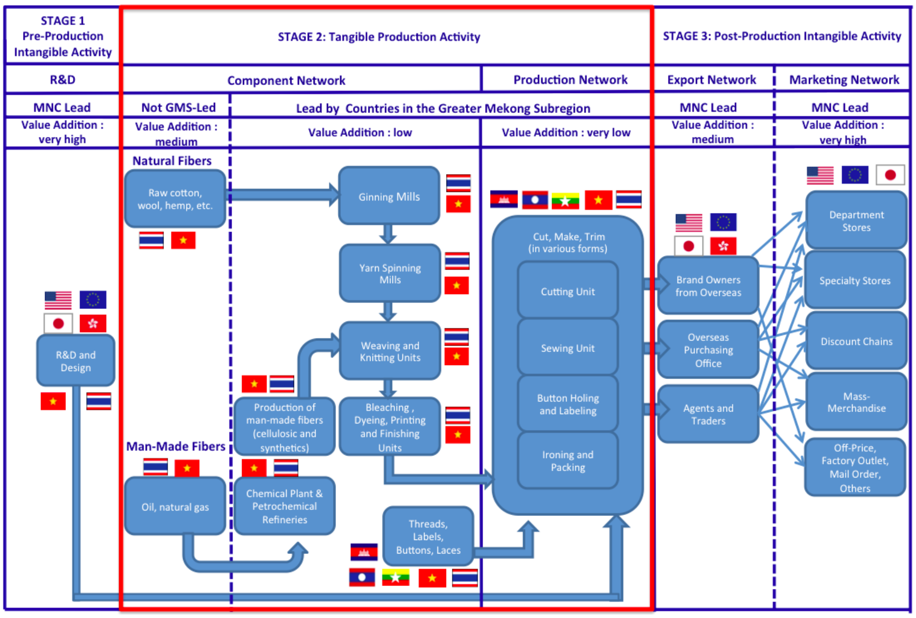
[17] See Abonyi, and Zola (2014) for more detailed discussion of this and other cases, and the general issue.

Figure 2.16: Thailand – Cambodia Cross-border Linkage in the Hard DiskDrive (HDD) Global Value Chain



Source: UNESCAP (2012).

Figure 2.17: GMS Cross-border Value Chain in Garments and Textiles: *Potential for new linkages?*



Note: This methodology of value chain mapping is useful ,for example, identifying the potential for establishing a cross-border special economic zone at Myawaddy (Myanmar) and Mae Sot (Thailand). See Abonyi and Zola (2014) .
Source: UNESCAP (2012); Abonyi and Zola (2014).

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