

## **EXECUTIVE SUMMARY**

### **1. Background and research objective**

ASEAN adopted the Policy Blueprint in 2004-2014 that outlines the framework for SME development for equitable economic development in the ASEAN region. Among the actions is the promotion of SME networking and their participation in the regional production and distribution networks.

Production networks models postulate that there are at least two-tiers of suppliers that provide a flagship company, or assemblers of final goods, with intermediate inputs. SMEs are usually part of firms in the lower-tiers. The main competitive value of firms in these tiers come from the low cost structure and high degree of flexibility. However, a significant proportion of SMEs are also at risk because of the more liberalized and fiercer competitive environment. Therefore, there is always survival threat because SMEs are located in the weakest link in a production network.

This research project aims at improving our understanding on how to effectively increase SMEs participation in the East Asian production network and what their issues and challenges are. The research does not only contribute to filling the theory-practice gap, but also lay down a good foundation for designing national arrangements as well as a regional institutional framework for supporting SMEs. In the attempt to achieve this objective, the study puts forward two interrelated questions: (1) what are the constraints of SME growth, both in general and according to the status of SME participation in production networks?, and (2) which firm characteristics determine SME participation and performance in production networks? Answering the questions extend the previous studies by an attempt to create an integrated understanding about the situation at regional level.

## **2. Summary of Key Findings**

Empirical analyses conducted by member of this research project produce some interesting and useful findings.

First, on the results that utilize all observations in the sample (or the integrated results/study), investigation based on perception survey indicates differences in the constraints facing SMEs that operate in production networks, compared to those that do not operate in the networks. SMEs in production networks consider distribution-logistics and business environment barriers more importantly than those outside of the networks. Both of the descriptive and econometric results suggest that productivity, foreign ownership, financial characteristics, innovation efforts, and managerial/entrepreneurial attitude are the important firm characteristics that determine SME participation in production networks.

The investigation is extended by analyzing the issue of SMEs and moving up to higher quality tiers in production networks. For those that are in lower quality of production network, internal constraints are critical to them in contrast to external constraints faced by those that are in higher quality of production network. Meanwhile, the econometric analysis reveals similar characteristic determinants as those in SME participation. That is, foreign ownership, productivity, and access to finance, as well as capability of SMEs in servicing their debts determine the chance of SMEs operating in lower tiers to move up to the higher tiers. Meanwhile, the notable difference is that, now size becomes an important determinant while effort to innovate and managerial attitude become less important determinants.

Second, there seems to be a picture that in some countries, SMEs are significantly constrained by their internal resources in performing well and improving the chance to participate in production networks. The results from Cambodian country-paper, for example, indicate that firms outside of production networks suffer substantially from the lack of financial and managerial capability, inability to compete with other firms, and difficulty in having wider information/networks. All these weakness also appear in the results and analysis of the country paper (i.e., the Vietnamese and Laos country paper). In addition, the results coming from these countries' study underline the barriers that

SMEs face to either acquire advanced technology, or even just to improve their technology capability. As noted in the Vietnamese study, all these weaknesses often lead SMEs in these countries for not being able to meet the strict quality-standard of goods demanded by other firms in higher tiers of a production network.

Third, rather in contrast, the results coming from the studies of some other countries, which happens to be the more advanced or older ASEAN countries (i.e. Thailand, Indonesia, and to some extent the Philippine), suggest that SMEs in these countries do not consider the internal resource as their biggest weakness, or posing the greatest barriers, for their performance. Firms in these countries thus have ability to engage in production networks. These studies claim that unfavorable business environment or direct investment climate are the more important barriers. In other words, these SMEs care more about external barriers rather than internal barriers.

Fourth, access to finance poses a binding constraint for most SMEs in the countries covered by the study. This is bearing in mind the two different impressions mentioned in the previous two points. Meanwhile, findings from country studies underline and are consistent with the findings from integrated results in suggesting the importance of having higher productivity and sufficient technology capability for higher probability to participate in production networks.

Fifth, learning from the Japanese SMEs that operate in countries in East Asia, competitive SMEs are likely to expand their operations both domestically and internationally, mainly in East Asia, by effectively being involved in the production/distribution networks in the region. To further develop international production networks and to deeply involve SMEs in the networks, various facilitation measures are important for both hosting and investing countries.

### **3. Summary of Policy Implications**

The following are the summary of policy implication that can be drawn from this study.

First, the study confirms the common understanding of most issues faced by the SMEs in region, such as poor access to finance, unfavorable business and investment environment (in broad view), and low internal capacity.

Second, though the low-quality and better-quality SMEs that participate in production networks share similar most serious constraints for development, there is a room for SMEs to upgrade their position, from lower to higher tiers, in production networks.

Third, an effective engagement of SMEs in production networks is also outcome of the interaction between several domestic and external factors, which can significantly affect SMEs' international linkages and production cost, and their ability to have new business and to expand production. This is particular the case of deeper regional integration and the institutional arrangements at regional level for supporting SMEs can play an important role.

#### ***Developing SMEs and Promoting SMEs to Engage in Production Networks***

Fourth, a multi-pronged approach is needed to tackle the lack of financing issue. Credit reporting agencies should be established either privately or publicly. Various credit guarantee schemes can be developed for helping SMEs to access to finance. It is preferable for private sector and business associations to be important players in these schemes. Direct financing for SMEs through stock market should bring into play. SMEs can also benefit from leasing activities in financing their medium and long term investment such as purchasing machineries and durable assets for their business.

Fifth, capacity building is an essential measure to strengthen SMES' managerial skills and capability. In particular, this helps SMES to meet the standard requirements (e.g. on project proposals, financial statements, accounting reports) for getting access to formal finance. Other important building programs are counseling and advice, business coaching, and short-run on-job training, training on modern management system, and training on (simple) information and communication technology.

### ***Promoting SMEs to Participate more Effectively in Production Networks***

Sixth, foreign ownership can play an important role in promoting SMEs to have higher-quality participation in production networks. Not only large foreign-invested enterprises as flagship firms, but foreign SMEs (especially those from advanced economies) can also have significant contribution for widening the value of regional production networks. Attracting foreign direct investment, therefore, should emphasize equivalently on both large and small and medium firms.

Seventh, firm technological and innovation capability is another determinant of the quality upgrading of SMEs in production networks. This requires a good infrastructure for technological transfer, namely modern telecommunication network, widely covered internet, highly qualified educational institutions, and IPRs protection.

### ***Strengthening the Regional Institutional Arrangements for Supporting SMEs***

All types of regional cooperation should have components for capacity building and for SMEs' development. The case of IAI is exclusion. Though SMEs share several similarities in terms of challenges/issues facing them, they are heterogeneous. At regional level, it is reasonable for having both general as well as selective and more focus programs to support SMEs. Once again, the exchange of professional, scholars, and entrepreneurs across the regions should be encouraged. This not only promotes information flow, but more importantly also enhances the knowledge stock of all countries, including those relevant for SMEs.

Third, as product standards may act as NTBs, the regional MRAs could facilitate SMEs access to market and lower transaction costs by eliminating duplicative testing. Thus, the MRAs could also deepen SMEs participation regional production networks. There has been progress in reaching some MRAs among ASEAN countries. But the way to go is still far from the destination. MRAs are needed for various goods produced in East Asia and they must be carefully devised to ensure that the lowest quality does not become the standard.