

**Economic and Social Council**

Distr.: General
4 May 2011

Original: English

Economic and Social Commission for Asia and the Pacific
Committee on Trade and Investment**Second session**

Bangkok, 27-29 July 2011

Item 8 of the provisional agenda

Integrating small and medium-sized enterprises into the regional economy**Integrating small and medium-sized enterprises into the regional economy****Note by the secretariat***Summary*

Despite their tremendous potential, small and medium-sized enterprises in Asia and the Pacific currently face significant resource constraints and have limited capabilities to compete effectively in global and regional markets. Although more reforms in policies concerning such enterprises have been witnessed in the region, isolated efforts to energize the sector may not achieve a significant degree of success unless the complex issues and processes concerning the development of small and medium-sized enterprises and their role in emerging global value chains in the region are well understood.

The present document reviews trends and issues related to the development of the small and medium-sized enterprise sector in Asia and the Pacific. Adopting the global value chain approach, it identifies the challenges and opportunities involved in improving the competitiveness of small and medium-sized enterprises, including the roles of intraregional foreign direct investment flows and corporate social responsibility. It elaborates on options for accelerating the development of these enterprises in developing countries of the region. It also discusses the role of ESCAP in addressing these issues.

The Committee may wish to deliberate on the issues discussed in the present document and, in particular, the role of the secretariat in addressing them.

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I. Introduction

1. The present document is a summary of chapter 7 of the *Asia-Pacific Trade and Investment Report 2011*.¹ The document reviews the role of small and medium-sized enterprises (SMEs) in development and the problems and obstacles they are facing to compete effectively in the global and regional economies. The document concludes by summarizing the main policy options for integrating SMEs into global and regional value chains and the role of ESCAP in this regard.

2. SMEs remain a critical source of employment creation as well as income generation in Asia and the Pacific. While they enhance dynamism in economies by bringing flexibility and fresh ideas, they can also stabilize societies by providing safety nets to disadvantaged workers. In this regard, the SME sector has occupied a prominent position in the development agenda of all developing countries in the region; thus, the promotion of SME development has been regarded as an important policy issue in countries of the region.

3. With the increasing attention paid by governments to SME development, more reforms in SME policies have been witnessed in Asia and the Pacific. The importance of SMEs that are active in export-oriented production and services, and in supporting industries for export, has been recognized in the export- and foreign direct investment (FDI)-led development strategies adopted by almost all Asia-Pacific countries. SMEs in the region presently face significant resource constraints, however, and they have limited capabilities to compete effectively in the global and regional markets. Despite their tremendous potential, SMEs are still in a disadvantaged position with respect to essential business requirements, such as capital, profitability, management, workforce, brand and network. Unless the complex issues and processes of SME development are well understood, isolated efforts to energize the SME sector may not achieve a significant degree of success.

¹ ST/ESCAP/2596.

II. The status of the small and medium-sized enterprise sector and its development

4. Over the years, SMEs have made a laudable contribution to the economic development of various countries in Asia and the Pacific. Their role in development has been mainly to: (a) create employment; (b) increase outputs with value added; (c) nurture entrepreneurship; (d) accumulate skills and knowledge; and (6) foster women and youth entrepreneurs. The development of SMEs contributes to increased gross domestic product and poverty alleviation. In both developing and developed economies, including those in Asia and the Pacific, it is clear that SMEs dominate, in most cases accounting for over 99 per cent of all enterprises. Not surprisingly, SMEs employ the majority of the workforce; about 60 per cent of the workforce is typically employed in the SME sector.² SMEs typically account for a higher share of job creation than large enterprises and have proved to be key players in achieving economic growth in the Asia-Pacific region.

5. Another important contribution of SMEs has been to exports, in terms of both volume and diversification. Export operations also expand the base of domestic enterprises and allow them to develop the capacity to compete globally. Thus, SMEs contribute to national competitiveness in addition to generating income. The share that SMEs contribute to exports varies widely among countries in the Asia-Pacific region and lies between 14 per cent (Malaysia) and 69 per cent (China).³ This varying ability of SMEs to export may be seen as an indication of how they can or cannot compete in regional and global markets and where specific support measures may be needed to improve their performance. Additionally, the share that SMEs contribute to exports is generally higher in the Asia-Pacific developed economies than in the developing ones.

6. The strategic importance of SMEs in overall economic development was widely recognized in the past and has been even more evident in recent decades, with no exceptions in either developed or developing nations. Within this context, some governments, in collaboration with bilateral and multilateral development agencies, have designed and implemented SME development interventions in Asia and the Pacific, particularly in less developed economies. The extent of those interventions has ranged from small, short-term ad hoc projects to multimillion-dollar, multi-year programmes. Specific and detailed interventions of SME development programmes designed to improve value additions in the SME sector and strengthen the contributions of SMEs to their respective economies broadly cover seven key areas: (a) the creation of a favourable policy and regulatory environment, including an effective institutional framework and a pro-business fiscal policy; (b) providing support for business infrastructure; (c) entrepreneurship development, including management skills and human resources development; (d) adequate access to finance; (e) technology capability-building and adaptation; (f) business development services; and (g) corporate social responsibility. The findings strongly indicate that a comprehensive SME development approach typically covers all or some of the aforementioned areas, which need further strengthening. With the active involvement of all stakeholders, particularly SME associations and chambers of commerce and industry, and government efforts to solicit

² See *ibid.*, part II.

³ *Ibid.*

significant donor assistance, the required environment for SME development can be strengthened.

7. Based on this analysis, several key points can be made for future technical assistance programmes for SME development in Asia and the Pacific. First, there seems to be a commonly agreed approach for SME development, covering the seven key areas outlined above. However, such a comprehensive approach has not been fully adopted by all development agencies and donors, which has resulted in scattered activities in various sectors, and the resulting lack of coordination of donor activities has produced limited results. Second, the right environment and a culture of entrepreneurship have been recognized as key success factors for SMEs to grow and be competitive. Traditional technical assistance, however, has not focused on this issue. A comprehensive “entrepreneurship training programme” should be launched, particularly in rural areas. Special preferences could be given to women and youth entrepreneurs. Third, conventional technical assistance to SMEs has neglected the important area of technology development and adaptation; thus, SMEs are weak in solving technical issues. Finally, the importance of the penetration of SMEs into regional and global markets has attracted more attention. Technical assistance for SMEs has typically focused on domestic issues, failing to recognize linkages with existing trade and FDI-driven development strategies.

III. The emergence of global value chains and opportunities for small and medium-sized enterprises

8. As mentioned above, one of the most crucial challenges facing SMEs in Asia and the Pacific is how to create new business (thus investment) opportunities for them in global and regional markets, in particular in major emerging economies in Asia and the Pacific, such as China and India. In small economies with a limited domestic market, exports play a crucial role in achieving high economic growth and rapid socio-economic transformation. SMEs that supply competitive products and services with greater potential for backward and forward linkages could substantially contribute to exports and, hence, to higher national incomes and the overall socio-economic progress of countries. Therefore, the development of export-led SMEs should be an important part of a country’s economic development strategy.

9. In this respect, recent experiences from a wide range of Asian and Pacific countries, particularly in North-East Asia and South-East Asia, strongly indicate that domestic SMEs can access international markets through global and regional value chains. These value chains provide a full range of value added business activities across borders and bring a product or service from its conception through design, the sourcing of raw materials and intermediate inputs, production, marketing, distribution and support to the final consumers. Such chains are expected to provide an efficient network by establishing linkages with large enterprises or even with other efficient SMEs. They help to boost the value added activities of SMEs in international trade, as SMEs at present play a limited role due to low value addition and a lack of proper networking.

10. Increased intraregional FDI has accelerated the development of global and regional value chains in Asia and the Pacific. Anecdotal evidence reveals that developing countries in Asia and the Pacific are

gaining importance as sources of FDI in the region, complementing FDI from the traditional sources in developed countries.⁴ It is noteworthy that, compared with the more industrialized and higher-income countries, lower-income countries have experienced increasing shares of intraregional FDI flows. This indicates that lower-income countries have received FDI from the more advanced neighbouring countries, which provides evidence in support of the “flying geese” paradigm, according to which less developed economies industrialize more slowly than their more developed neighbours and are engaged in a process of catching up to them. This trend is expected to lead to a gradual industrial transformation from relatively low value added sectors, such as the agricultural and garment sectors, to high value added sectors, such as automotive parts and electronics. In this connection, it may be desirable to explore investment opportunities for SMEs in advanced manufacturing and related value chains.

11. Within this context, the practical challenge for SMEs in Asia and the Pacific is how they can upgrade and become and remain competitive suppliers in particular global and regional value chains. In order to participate effectively in these chains, SMEs must break high entry barriers by meeting a wide range of increasingly stringent global standards and other requirements with respect to quality, price, timely delivery and flexibility. Individual SMEs seeking to establish partnerships in global and regional value chains should understand how the process and structures of the specific value chain they are targeting are governed, especially as international trade and global and regional value chains are dominated by large firms with global brand name recognition. It is well understood that a product’s quality and value depend not only on innovations in the production process but also on innovations outside production, such as design and marketing, and management practices that conform to consumer expectations, including corporate social responsibility. SMEs also need to implement these innovations to enable them to cater to a wide range of market niches and destinations. Thus, governments and business associations should provide various support services to SMEs for that purpose. In the absence of such services, SMEs in Asia-Pacific developing countries would not be able to establish effective value chain connections at the regional or global levels.

IV. Policies and opportunities for the development of small and medium-sized enterprises

12. On the basis of the above analysis and considerations, the following opportunities for SME development and related policies in Asia and the Pacific can be identified:

(a) *Opportunities for new entrants.* It is now possible for SMEs to become internationally competitive in an increasingly wide range of industries based on a single function or a small number of functions as suppliers in global and regional value chains. Similarly, through participation in these chains, it is possible to achieve large-scale exports of specialized outputs in niche product markets that are regional or even global in scale. Ultimately, SMEs can emerge as overseas investors in their own right and, as they grow, develop their own value chains by forging backward and forward linkages;

⁴ *Asia-Pacific Trade and Investment Report 2010: Recent Trends and Development* (ST/ESCAP/2590). Available from www.unescap.org/publications/detail.asp?id=1425.

(b) *Opportunities for value creation.* In a world of global and regional value chains, key differences in the competitive performance of SMEs lie less in the industries they are in than in the functions or activities in which they choose to specialize. It is not the industry or sector that is most important, but rather a firm's core capabilities within a particular industry value chain. Opportunities for value creation can exist anywhere along the industry value chain through specialization and upgrading;

(c) *"Match the best".* International business is increasingly characterized by fragmented and specialized production within the framework of global and regional value chains, driven by strategic decisions on the reorganization and relocation of production. To be competitive, SMEs have to be able to continuously match their performance to the "best in their class" for each activity or function or output they choose to keep, for example manufacturing activities, design, logistics and marketing. Unless they are able to "match the best", they are unlikely to be able to compete effectively in regional or global markets, given the range of globally available supplier options in most industries;

(d) *Cooperate to compete.* Cooperation through SME clusters plays a key role in the achievement of competitive success for SMEs in the region. Such SME clusters are anchored in partnerships along three dimensions: (i) partnership among SMEs, through joint task-related activities and initiatives that also support the building of trust and shared experiences; (ii) partnership between core producer enterprises in such clusters and supporting institutions that provide key services, such as training, logistics and business development; and (iii) cooperation between business and government to strengthen business institutions related to global and regional value chains;

(e) *New challenges for development strategy.* Local SMEs must increasingly have the required capabilities to even be considered by first-tier global suppliers or lead firms in global and regional value chains. In this context, a key role of government is to assist in developing the required supplier capabilities, including by helping to strengthen industry-related institutions, as well as ensuring the availability of competitive support systems, such as logistics services. This is essential to support the competitive performance of domestic firms in international markets and increasingly also to attract investment.

13. The transformation of regional businesses through the emergence of global value chains signals potentially new and important directions for SME development in Asia and the Pacific. The global and regional value chain approach, in particular, provides four advantages for SME development at the national and regional levels. First, in recognition of the diversity of the developing countries of the region in terms of both their economic status and condition and their natural endowment, the approach based on value chain (and thus specific sector) could identify development issues more easily, while the one-size-tailored approach may not be workable in all participating countries. Second, the approach covers the seven essential issues for SME development mentioned in paragraph 6 above. Third, the value chain approach will force policymakers to adopt a programme for regional cooperation which moves the development assistance paradigm beyond national borders. Fourth, the value chain approach is closely linked to the attraction of appropriate FDI, as FDI plays an important role in the development of value chains. This approach therefore also helps to promote intraregional FDI.

V. ESCAP activities

14. Against the above background, ESCAP has been working closely with various countries and subregions in implementing a series of technical assistance activities for SME development since the early 2000s. ESCAP recently initiated the implementation of a technical assistance project with financial support from the Government of Japan on promoting the participation of SMEs from the Greater Mekong Subregion in regional and global value chains.

15. Through its Investors for Development (I4D) project, ESCAP aims to strengthen national global compact networks and assist SMEs in increasing their competitiveness by embedding the principles of the Global Compact Initiative and corporate social responsibility in their core business strategies.

16. In December 2010, a stakeholder consultation meeting was conducted for less developed countries of the region on their technical assistance needs in promoting and facilitating inclusive and sustainable FDI. Based on the outcome of that meeting, a technical assistance programme was developed and will be circulated to potential donors in due course.

17. ESCAP also organizes the annual Asia-Pacific Business Forum (APBF) in order to promote public-private dialogues on issues of mutual interest, such as favourable business environments and business competitiveness. The Asia-Pacific Business Forum 2011 is scheduled to be held in Bangkok on 25 and 26 July 2011 as part of the Second Asia-Pacific Trade and Investment Week (25-29 July 2011).

VI. Issues for consideration by the Committee

18. The secretariat has strived to strengthen the supply-side capacity of the countries in the region through the activities described above. In view of the considerations in the present document, the Committee may wish to review the role of the secretariat and to deliberate on the following potential activities:

(a) The adoption of an export-led SME development strategy based on the global value chain approach;

(b) The promotion of corporate social responsibility in the private sector and the inclusion of corporate social responsibility in an inclusive and sustainable development agenda;

(c) The promotion and facilitation of intraregional FDI flows to less developed countries.

19. The Committee may wish to deliberate on the issues discussed in the present document and, in particular, on the role of the secretariat in addressing these issues.