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Gearing Up For ASEAN Economic Community: Small and Medium Enterprises Response and Preparedness to Regional Market Integration*

Introduction

ASEAN Economic Community (AEC) is aimed to accelerate transformation of Southeast Asia region into a more stable, prosperous, and highly competitive area with equal distribution of economy development, reduced gap of social-economy and poverty. The creation of AEC, which was then embodied in the blueprint, consists of free trade of goods and services, investment, asset, and mobility of skilled human resource in service sector. In a nutshell, AEC eliminates most of intra-ASEAN trade barriers, creates trade facilitation and policy harmonization programs. An effective AEC implementation ideally facilitates efficient process for production of goods or service beyond national borders regionally.

Problems arise when the short term reality of Small and Medium Enterprise (SME) development are way from the vision of AEC. Hoi (2012) identified challenges such as how regulation can balance the massive flow of direct investment with SME growth. The other challenge is the heightening competition in product efficiency when local product and imported one are facing each other. In fact, there are some problems faced by SME in Indonesia. Human resources problem, low access to capital, and limited market access seem far from being resolved. This fact is certainly concerning; because the number of SME in Indonesia is much higher than large enterprises. The percentage of SME consistently stands at 99% of the total enterprises in Indonesia since 2009.In terms of employment contribution, SME utilizes more than 97% of the total number of employees working in private sectors.

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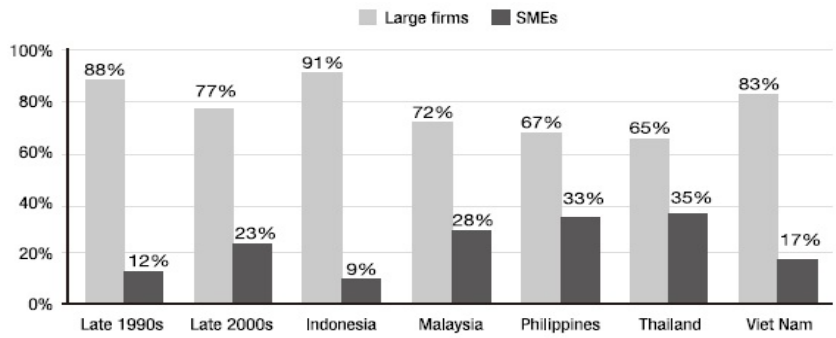
Table 1. The Comparison between SME and Large Enterprise in Indonesia

	2009	2010	2011	2012
BUSINESS UNIT				
SME	52.764.603 (99,99%)	53.823.732 (99,99%)	55.206.444 (99,99%)	56.534.592 (99,99%)
Larger Enterprise	4.677 (0,01%)	4.838 (0,01%)	4.952 (0,01%)	4.968 (0,01%)
CONTRIBUTION TO NON-OIL AND GAS EXPORT				
SME	162.254,5M (17,02%)	175.894,9M (15,82%)	187.441,8 (16,44%)	166.626,5 (14,06%)
Larger Enterprise	790.835,3 (82,98%)	936.825 (84,19%)	953.009,3 (83,56%)	1.018.764,5 (85,94%)

Source : The Ministry of Cooperatives and SME of the Republic of Indonesia, 2013 (data processed)

The stumbling blocks in terms of resources, capital and access could be some variables determining the low SME contribution to export. It is interesting to note that even though the number of SME is higher than large enterprise, their contribution to export is not significant compared to their large counterparts. Figure 2 illustrates the total SME contribution toexport has never accounted more than 9% of total non-oil exports from Indonesia. This figure also shows more concerning issue; Indonesia's SME contribution seems much lower than other ASEAN Six such as Malaysia (28%), The Philippines (33%), Thailand (35%) and additionally, Vietnam (17%).

Figure 1. Comparison of total exports of large enterprise and SME in Indonesia and Southeast Asian countries



Source :Wignaraja (2012) in Sato (2013)

The problems faced by Indonesian SME potentially hinder this sector to be able to compete regionally. On the other hand, *Negative Spillover Effect* or the challenge of incoming cheaper imported product is inevitable. Indonesia has experienced implementation of the ASEAN-China Free Trade Area (ACFTA) in 2010. It is general knowledge that Chinese product were able to compete in Indonesia's domestic market. Regardless its quality, Chinese product offered cheaper option with wide range of varieties that are favorable to wide segment of local customers.

As the implementation of AEC is approaching near, various institutions were involved in measuring domestic market preparedness to the new regional economic landscape. One example, national government approach to measure preparedness is mapping policy liberalization list that complies AEC Blueprint. It shows how far Indonesia's policy accelerates its market liberalization to catch up with regional requirements. Yet, this approach does not illustrate domestic stakeholders' preparedness to AEC. Therefore, it is intriguing to question: *How are the capacities of SME to face AEC? How are they responding the change?*

Strengthening The Role of SME in Times of Regional Economic Integration: A Literature Review

In both developed and developing country, SME plays an important role in economy. In developed countries and newly industrialized countries (NICs), SME contributes as a subcontractor that provides a wide range of inputs for large-scale enterprises. However, the role of SME in developing countries is somewhat different from that in developed countries. The role of SME in developing countries is often more associated with government's efforts to overcome the economic and social problems, namely: reducing unemployment, poverty eradication, and the equitable distribution of income.

SME has complementary roles with large companies in the creation of employment opportunities and economic growth (Giaoutzi et.al, 1988, Armstrong et.al, 2000, Tambunan, 2000, Sudarto, 2001). Urata (2000) who had observed the development of SME in Indonesia revealed that SME played some important roles in Indonesia. Some roles are: (1). SME is the key player in economic activity in Indonesia, (2). Provider of employment, (3). Important player in local economic development and community development, (4).Creator of the market and innovation through flexibility and sensitivity and dynamic linkage between corporate activities, (5). Contributes to the increase in non-oil exports. Meanwhile, Tambunan (2001) stated that SME were also able to reduce income inequality, especially in developing countries.

Modern theory considers the importance of the existence and the development of SME related to flexible specialization in production and export. Piore and Sabel (1984) emphasized that SME was very important in the production process with the ability to specialize. With the ability to specialize, then there is a linkage between SME and large enterprises. It is very important for the development of SME and large industries and the economy as a whole. A linkage is a pattern of relationships among companies with mutual benefit. In this case, SME highlight their position as providers of spare parts and inputs for large-scale businesses through subcontracting pattern. The experience of developed countries such as Europe, the United States also recently industrialized countries (NICs) such as Korea, Japan, where SME is very important as supporting industries that provide inputs, spare parts and other components needed for large-scale industrial production processes.

The role of SME in Indonesia is more associated with the classical roles that are related to overcoming unemployment and equitable distribution of income. In addition, SME in Indonesia still has a strategic position that can't be ignored. First is the capital aspect. SME does not require a huge number of capital as large company so that the formation or the entry to this kind of business is not as difficult as large company. Second, in the aspect of skills and education small industries do not require certain high/formal education (Tambunan, 2000). Most of the human resources required by small industries arebased on experience (learning by doing) that related to historical factors or path dependence. It is often found in crafts, carving, and *batik* industry. Third, is theirlocationalaspect,Most of the small industries is located in rural areaand does not require infrastructure as large companies (Rietveld, 1987, Weijland, 1999). Fourth is the aspect of endurance. It has been proven that small industry has survival against economic crisis (Sandee, 2000).

In the context of AEC, the blueprint of AEC considers important role of SME as the backbone of regional economy. SME is considered to bridge development gap among others through employment. In addition to the human resources factor, the East Asian Summit in 2011 emphasized the importance of the role of SME as a vehicle to accelerate the growth of the ASEAN region, balancing domestic and regional needs including inclusive growth catalyst.

The vision of SME development in ASEAN APBSD (ASEAN Policy Blueprint for SME Development) framework *is "The Blueprint aims to facilitate the emergence of an ASEAN SME sector that is entrepreneurial, outward looking, competitive and resilience"*. Strengthening the role of SME in the ASEAN Community is directed through two contexts. First, through their participation in regional production networks as part of the production chain of a multinational company and second, through the inclusive way that is developing capacity of SME that is expected to work together with community development.

Levy, Berry and Nugent (1999) stated that SME are in a less favorable condition to participate in regional production network. SME faced constraints in information, financial, managerial capacity and technology so that the probability of SME participation in regional production networks becomes smaller than their counterparts such aslarge companies. Such condition applies toSME in ASEAN as well, SME in ASEAN are not be able to participate in regional production networks. The data shows, only SME in Malaysia and Thailand are quite competitive. SME participation rates in the two countries reach 60%, while Indonesia is only 14%.Besides the capacity factor, Lim and Kimura (2010) argued that SME lies on its network to be able to participate in regional and international networks. From the networks they acquire market knowledge and reaching more opportunities. Basically SME that attempts to engage in a regional network must understand the market where they will operate.

The low participation of SME in the regional production networks provides context that development capacity of SME via inclusive path becomes crucial. Sato (2013) argued that the SME in ASEAN generally had micro-scale and located in rural areas that based around agriculture. Small business units are mostly constrained by the problems of access to finance and the broader market. SME in ASEAN, especially Indonesia is also categorized as a missing middle (Sato, 2013). Missing middle describes the conditions where SME can absorb a lot of human resource as they work with low productivity without high technology. Therefore, the first phase of APBSD before the implementation ofAEC in 2015 decided to focus in developing SME through direct and indirect support.

The role of government in supporting SME in ASEAN directed through the following policies:

1. Direct support for the development of SME through capacity development programs.
2. Indirect support in creating a conducive business environment for SME development
3. Formulating policies that matchASEAN regulation to support the implementation of effective policies.

Aldaba (2013) further emphasizes the classical role of government, especially in increasing SME capacity to prepare for AEC 2015 is not enough. The government needs to improve promotion and regulation that encourages SME participation inregional production networks. In addition, to prepare for SME in times of regional economic integration, the government needs to do a series of policies such as:

a. Formulating coherent and multi-sector policies.
b. Increasing the awareness of SME to be involved in regional production networks, including providing an understanding about the subcontracting process if necessary.
c. Resolving problems related to capital access by changing the mindset of financial institutions. Traditionally, the mindset of financial institutions is stuck in the view that SME have a low rate of loan repayment.
d. Specific training to enhance the managerial and financial capabilities, especially for export capacity.

The vision of SME participation to regional production network could be too good to be true for some experts. In 2010, Tambunan (et all) envisioned AEC and its impact to SME in four scenarios, both positive and negative. *First,* through regional competition.Tambunan suggested that tariff and barrier removal might increase competition. This situation will encourage local player to enhance their competitiveness through product efficiency. In long term, competitive player will survive while inefficient player will be eliminated.Tewari (2001) described a similar pattern in India. He stated that 15 years after liberalization some textile based SME were declining in terms of their production capacity and capital.*Second,* AEC will impact SME when prices of their products go down. Import fee elimination for raw materials and intermediate goods will help SME that relies on imported raw materials or goods to stay competitive. *Third,* through export meaning that removal of trade barriers will stimulate business to contribute for export. *Fourth,* when export has increased local players will face difficulties to access local based raw materials and intermediate goods.

Tambunan (2010) further argues that the key challenge of SME to survive in times of market liberalization relies on their capacities to compete with imported products. SME capacities depend on their production capacity, human resources, innovation, the use of technology, and willingness to improve their product quality. He sets several variables determining SME competitiveness. Internally, managerial capacity, strategy, corporate culture, access to capital and availability of raw material are mentioned to be the variables. In external box, Tambunan pointed out to infrastructure, location, regulation, access to raw materials and market, marketing strategy and institutional capacity.

Data collecting was conducted by a survey interviewing 410 SME located in Yogyakarta Special Provinces of Indonesia. Specifically, this study focuses on food processing and clothing based SME. The following section covers the rationale of selecting those two kinds of SME.

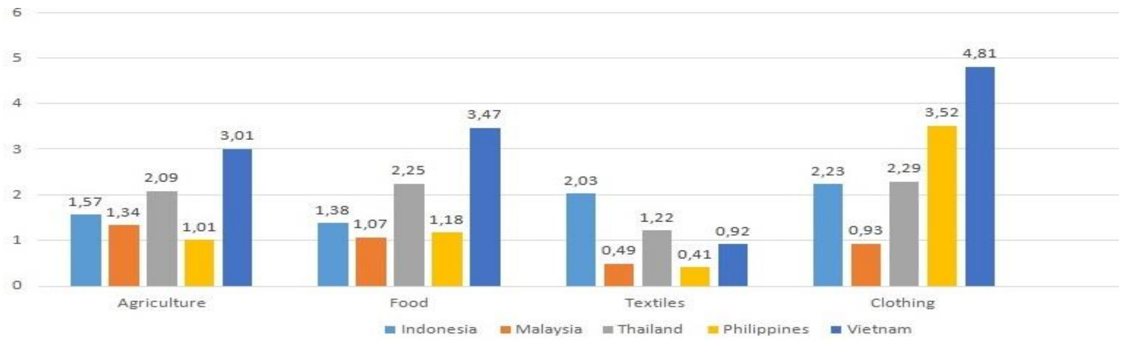
Clothing and Processed Food Based-SME: Small and Medium Enterprises in Yogyakarta

Yogyakarta Special Province of Indonesia (DIY) is one the provinces in the country that generates its economy from the SME businesses. The number of SME in DIY continues to increase every year. This study focuses in SME based in clothing and food processing because these are where the production process took place, also where the creativity and innovation of product development are done. With the innovations developed in the industrial sector, value-added and competitiveness of a product will increase. In addition, small and medium industries should be supported because they have great export potential.

Clothing industry, especially the textile apparel commodity, becomes a product that was ranked first in DIY exports with total value US$ 74,96 million in 2013. On the other hand, the food processing products are also significant contributor. This is because food-processing industry has the largest number of business unit with 38.291 SME. It is predicted to become one of the high competitive sectors in ASEAN market.

Further, food and clothing industries are on the top of products with the highest RCA (Revealed Comparative Advantage) for Indonesia. RCA is one of the popular methods that are used to measure product competitiveness. Based on the report of Chandran (2010) in Complementary and Similarity in Trade Between India and ASEAN Countries in the Context of the RTA, Indonesian products with the highest RCA products were clothing (clothing and textiles) and agricultural also food products (agriculture and food). In ASEAN context, we attempted to bring RCA data to a comparison. It reveals that Indonesian food products are less competitive than Vietnam, as well as in clothing. The latter products are still lagging behind Thailand, Philippines and Vietnam.

Figure 2. RCA of Indonesian product compared to similar product from ASEAN countries

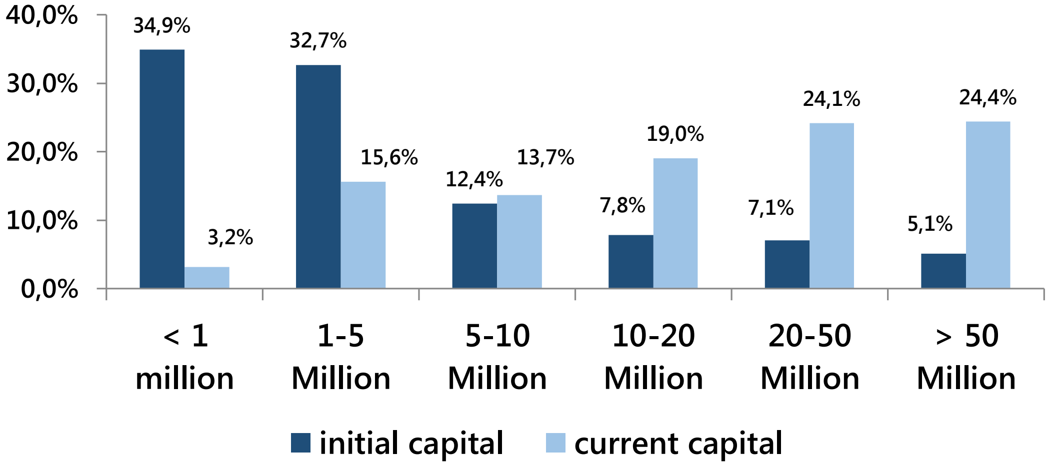


Source : WTO, 2010 (data processed)

Local SME Capacities: Access to Finance, ICT Utilization and Market Access (Linkages)

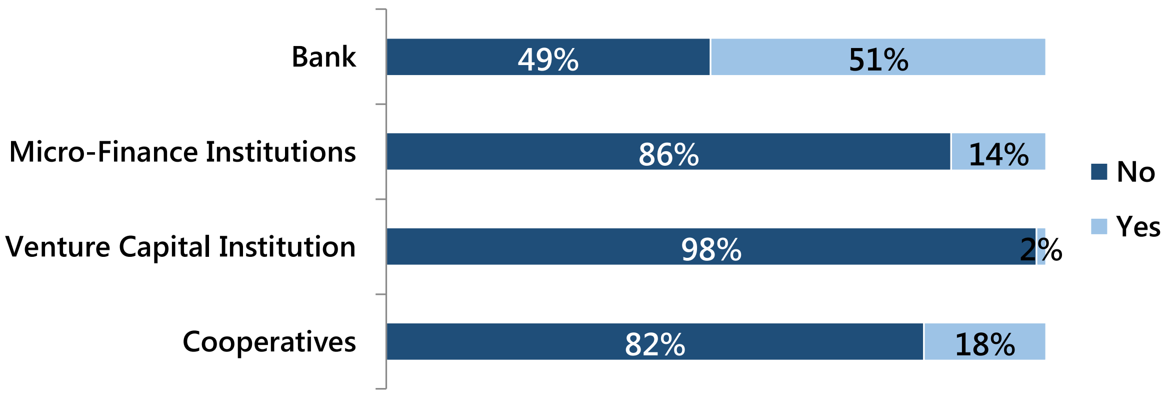
SME that we observed in survey demonstrated impressive growth. This indicates that their financial capacities were accelerating from time to time (see figure 3). At the initial phase, SME were grouped at the left side, whichmeans that they started their businesses from small amount of finance. On the contrary, current development shows the SME has been transformed as they grouped on the right side.When starting up, most of SME stated they spent their initial capital in less than one million rupiahs, the proportion of them is 34,9%. Meanwhile, 32,7% of them had initial capital around 1,5 million rupiahs. From these two conditions, it can be inferred that to start up a business, one does not require considerable amount of money.

Figure 3. SME Financial Capacity: Initial and Current Development



Another strategic issue related to finance is certainly SME access to finance. IFC (International Finance Corporation) report during The G20 Summit in Seoul 2010 described that the major constraint for financing the SME in developing nations was their access to major source of finance. Various data indicates that SME relied on internal financing rather than financial institution. The similar pattern appeared in our data, the major source of finance came from internally generated funds. Specifically their own savings or loans from relatives. Figure 4 depicts that only 51% of respondents said that they obtained loan from bank, 18% from cooperatives, 14% from micro-finance insitutions, and the least from venture capital institution which accounted only 2%.

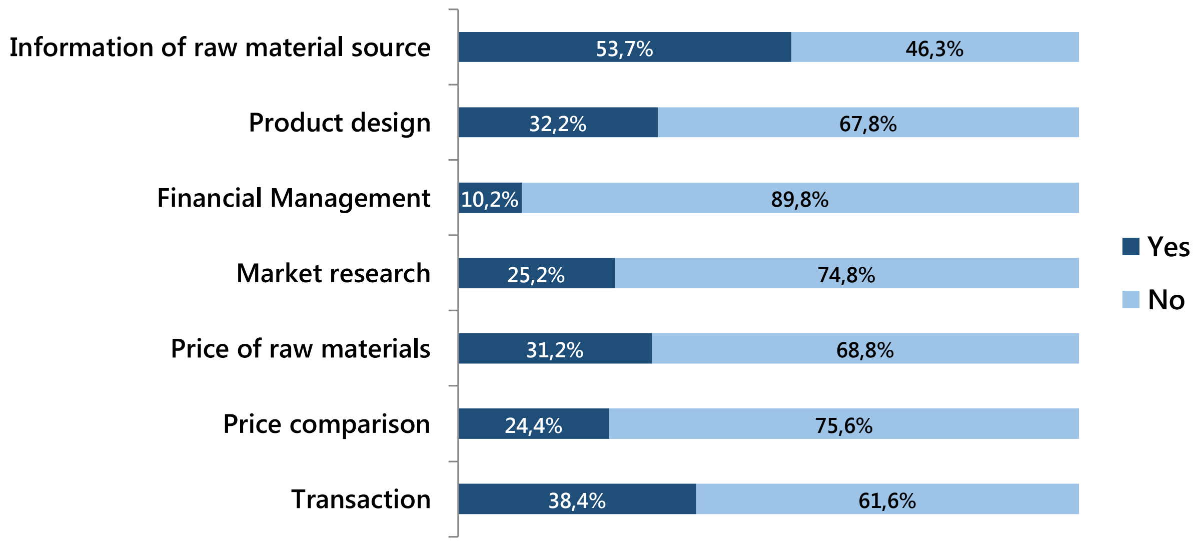
Figure 4. Major Sources of Finance



SME finance gap to access formal financial institution was due to their traditional characteristics. Some SME do not possess business license for their legal status. Such condition hinders SME to access formal financial institution. 63% of 410 respondents revealed that their business are not legally registered while 91% of them have unclear legal status. Consequently, they are not eligible for bank loans.

In terms of innovation, capacity of SME to innovate is important determinant of SME participation in production networks. One of the main factor is ICT utilization that facilitates SME to innovate, aside from the innovative managerial capacity and human resources. Some research found that ICT is important to SME because it helps them to develop organization performance and effectiveness. Schubert and Leimstoll (2007) conducted a quantitative study regarding the co-relationship between ICT usage and SMEs business objectives and the result was positive. The figure below shows the use of technology by SMEs.

Figure 5. ICT Utilization Among SME

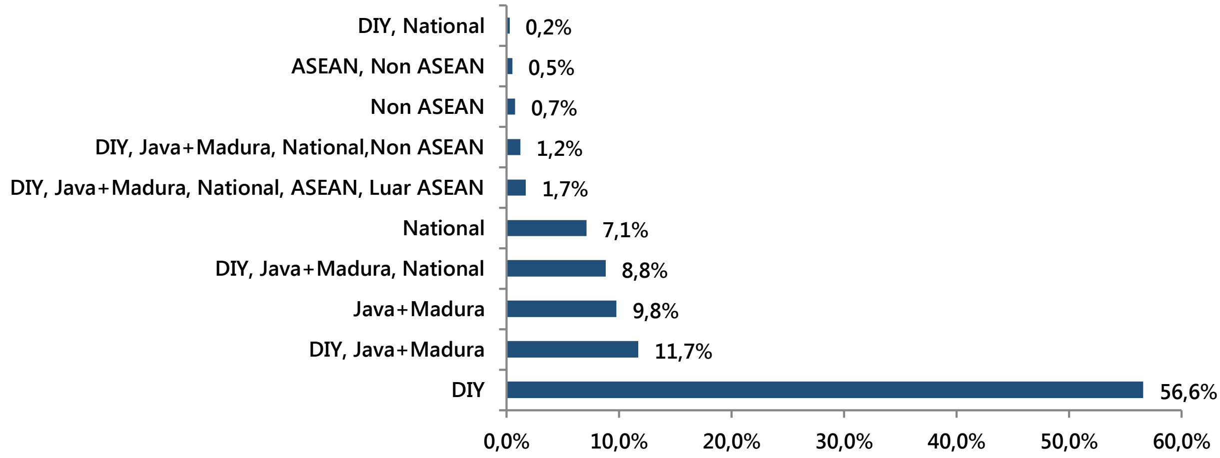


The above figure shows the low utilization of ICT among the SMEs. The most frequent use according to them was ICT utilization to browse information of raw materials source. Meanwhile, the utilization of ICT in some SME provide some reasons for optimism. SME are heading to maximization of e-commerce opportunity particularly through social media. Social media according to them provides a room for efficient method of marketing. They dont spend specific amount of money to publish their products. However, they assign part-time employer to keep their social media account updated and being responsive for customer demand.

Lastly, another crucial indicator to assess SME capacity is their linkages. Linkage may involve the production process and as well, marketing linkage. Marketing linkages related closely to product quality. The basic assumption is that the broader linkages SME possess, the better product quality they provide. According to McGrath, Helen (2008) Market orientation is the organizational culture that creates the necessary behaviors for the creation of superior value for buyers and thus continuous superior performance for the business.

For the case of food processed and clothing industry based SME in Yogyakarta, it can be seen that most of them has domestic oriented market. That means these two kinds of product are currently not bound for export. According to the figure 56,6% of them bound for local (provincial scope) market whereas for national level it accounted for less than 9%. There are several obstacles hindering SME for a broader market. The most crucial problem is product standard and certification that is crucial for export requirements. Among 410 respondents, 46% are not certified yet. Therefore, the lack of SME capacity to meet the standards has to be addressed by government by capacity building program.

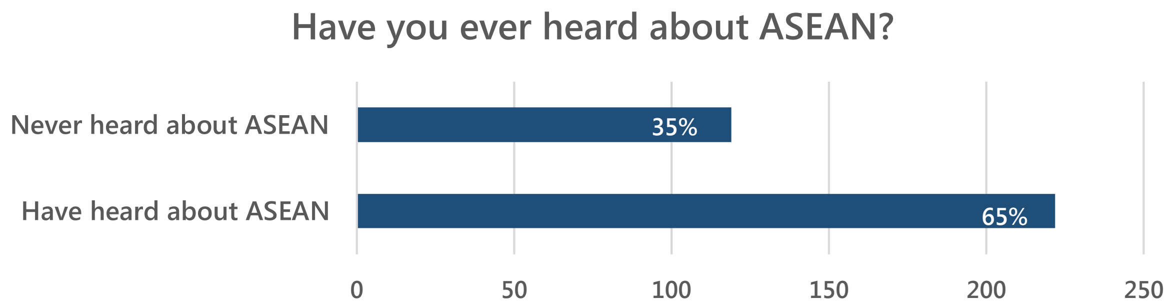
Figure 6. SME Market Orientation/Destination



Local SME Response and Preparedness to ASEAN Community

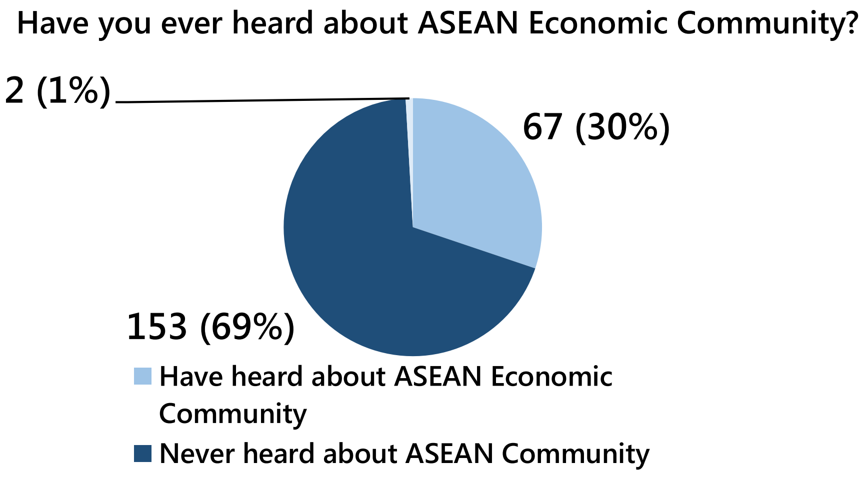
Understanding of 'what ASEAN is' plays crucial role in shaping SME response to ASEAN Community. Amongst 410 respondents that have been interviewed, it is evident that most of the respondents has heard ASEAN as regional entity. The figure below depicts 65% of SME owner are familiar with the term 'ASEAN'. This fact is not surprising, Indonesian education curriculum has introduced the knowledge on ASEAN since elementary school. Such curriculum has been implemented nationwide in social science particularly for history or geography classes. Yet, this ASEAN awareness building program is mere introducing ASEAN itself and its basic organizational structure, members and founding fathers in 1967.

Figure 7. ASEAN Awareness



Awareness building of ASEAN and its current development might be the most important area to be improved. Figure 7 captures that even though 65% of SME owner know ASEAN, 69% of them are not familiar with ASEAN community. Government and ASEAN Secretariat for instance has various programs to disseminate the blueprint of AEC. However, this effort must be accelerated as the implementation of AEC blueprint is approaching near. ASEAN Studies Center has hold a focus group discussion involving several government units to discuss local government preparation to AEC in Yogyakarta. The discussion brought up a reality that some representatives never heard of AEC such as officer in Agricultural and Farming Authority at the provincial level. The officer told us that even though agricultural industry plays a very significant role in shaping Indonesia's comparative advantage in regional context, the dissemination of such new economic landscape was minimum.

Figure 8

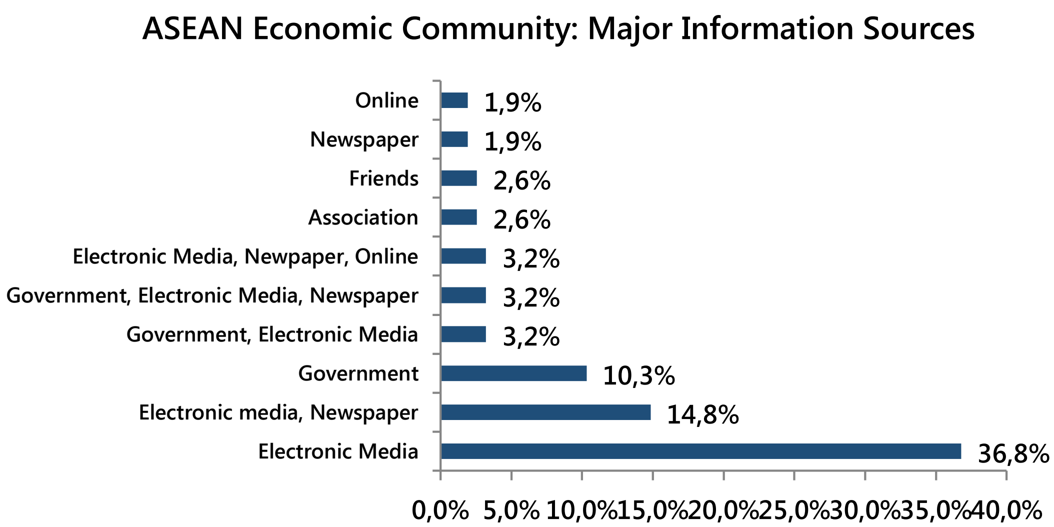


This lack of awareness among the public servant, may partly affect the level of SME awareness on AEC Issues. In a decentralized Indonesia, local government dominates program activities in their areas. Moreover, depending on central government support for AEC-related activities sounds impossible. The limit of central government authority and coverage at the entire cities are the reasons. Consequently, without sufficient knowledge of AEC and its significance to local economy, dissemination program delivered by public sector would not be priority. The know-how of AEC might not be disseminated largely among the SMEs. As a result, SMEs are not equipped well to face AEC.

Addressing this issue, local government argued that their focus for ASEAN Community related program are in SME owners with handicraft products due to their high contribution for export. According to public officials, Handicraft based SME owners have been approaching local government agency for industry, commerce and cooperative to conduct training before the beginning of AEC in 2015. SME owners perceived that capacity building program for know-how of AEC is crucial as such program has never been implemented. Government strategy to disseminate the know-how of ASEAN Community here seems right by trying to put effort on SME that possess export capability to compete in regional market. However, learning from the implementation of ASEAN-China Free Trade Area which came into effect in January 2010. Indonesia's market faced challenges as imported products continously entered local market. Local garment product, textille and processed food began to compete with cheaper Chinese product. One might argue that this condition possess challenge such as negative spillover effect.

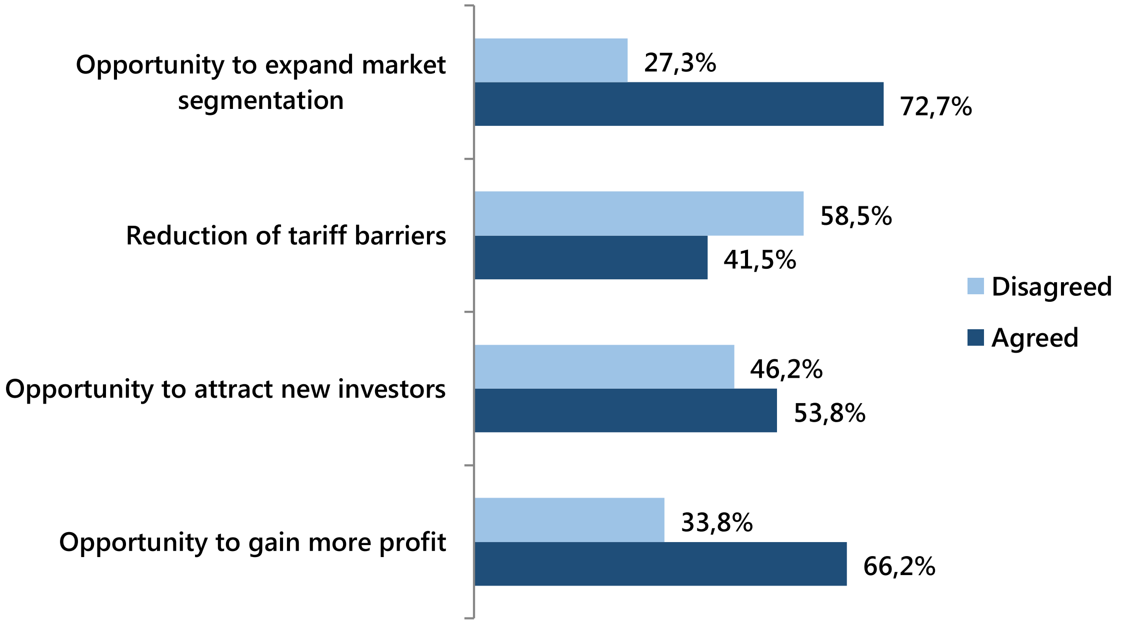
Recently in late August 2014, Ministry of SME and Cooperative released an advertisement sounding the challenge of AEC and their support in terms of institutional capacity building and SME loans. This could be the only public campaign through electronic media (such as TV and radio while internet was classified differently) on AEC in Indonesia. Government sees electronic media effectiveness to disseminate their programs. In june 2014 or two months before the campaign was launched, we further interviewed respondents who have heard about AEC. As it depicted in figure 9, nearly 37% of the respondent said they knew AEC from electronic media while 15% of them heard from both electronic and printed media (newspapers, magazines and etc), and only 10% knew from the government. This result seems in line with previous assumption that local government effort to introduce the new regional economic landscape was minimum.

Figure 9



Aside from information dissemination program, it is interesting to question SMEs perception of AEC. We divided the questionnaire into two different answers that enable SME to perceive ASEAN Community as opportunity and challenges. In terms of opportunity, major SMEs perceived AEC in positive ways. They grasped the new economic landscape as a chance to gain more profit, to attract more investors and to expand their market segmentation. However, tariff elimination for export remains a stumbling block. It is true that ASEAN 6 countries (Indonesia, Malaysia, Singapore, Thailand, Philippines and Brunei) has reduced their tariffs to nearly 90% to comply ASEAN integration scorecard but domestic challenges could be another obstacles. Added value tax, export tax imposed by government and complicated procedures are some obstacles that hinder SME to export according to the SME owners.

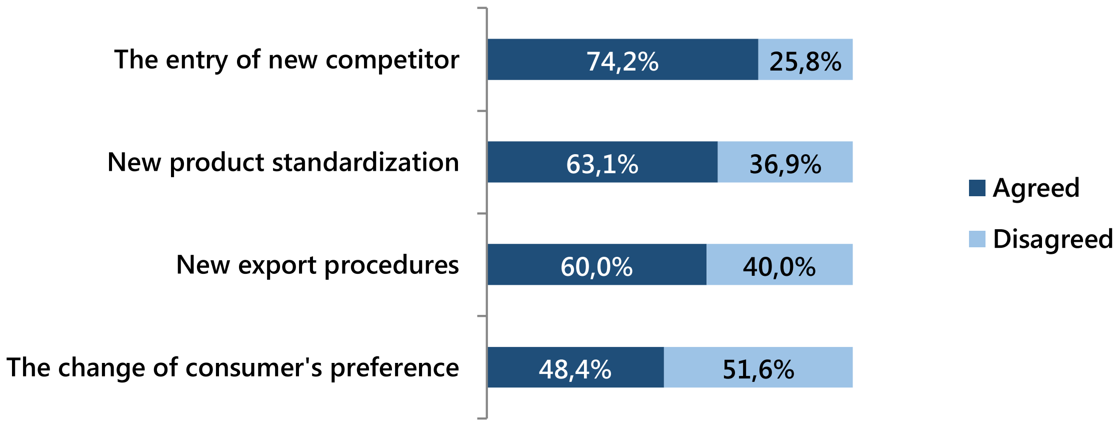
Figure 10. SME Perception of Opportunity in AEC



In the other hand, SME owners confirmed that AEC itself possess challenges. shows 75% of the respondent affirmed the entry of new competitor from their neighboring countries as a challenge. They also believed that there are some new product standardization applied for export with different procedures.This perception signifies a condition where SME owners are aware with fundamental change in 2015. The awareness of new competitor entry ideally implies that SMEs could not operate on the same way. In order to compete, innovation and proper strategy is necessary.

Nevertheless, SME did not predict consumer preference change would take place significantly. This perception appears due to local characteristics and contents in products they sell. Batik product for example, its traditional pattern and handmade production mechanism are difficult to be replicatedby competitors in regional market. As well as Batik, traditional food industries perceived in similar pattern. Despite the need of upgrading their packaging and complying HACCP standards, local SME appears to be confident that 'local taste' prevails as their comparative advantage. Such confidence indicated more in further question, 67% of SME stated that they did not specifically prepare themselves to face the challenges of AEC.

Figure 11. SME Perception of AEC Challenges



Conclusion

A year before AEC (for ASEAN 10 free trade area) is fully implemented, it can be concluded that there are many areas for SME to be improved. SME in Yogyakarta were generally enjoying periods of massive growth. Yet, in terms of capacity, lack of access to formal financial institution was concerning. The issue of legal license as primary requirement for accesing loans must be first addressed. In addition, public sectors are suggested to encourage ICT utilization. As the regional market opened and people connected each other closely, SME product marketing should embrace new ways to approach the new regional landscape. This approach could also support SME to reach market beyond their limits. The survey illustrates that SME with domestic market oriented are dominated.

SME low awareness to ASEAN Economic Community is another crucial issue. Despite the popularity of ASEAN as regional entity, most of the SME was not exposed to AEC and its current development. Those who understand the challenge of AEC perceived a liitle opportunity behind trade barriers elimination and facilitation. Local barriers such as infrastructure, value added tax and little incentive for export contribute to decreasing benefit of tariff elimination. Furthermore, some SMEs are gearing up for more changes as they aware of several changes occur as inevitable consequences of AEC. They aware of new competitors entry to domestic market, new product standardization and new export procedures. However, they dont perceive consumer's change as some products they market possess local contents.

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