Economist Intelligence Unit | The Economist

Towards the recovery:
Challenges and opportunities facing Asia's SMEs

A report from the Economist Intelligence Unit

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Contents

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About the report

The Economist Intelligence Unit’s editorial team identified interview targets, conducted the interviews and background research, and wrote the report. The findings in this paper reflect the views of the Economist Intelligence Unit alone. Charles Lee wrote the report and David Line was the editor. Gaddi Tam was responsible for design and layout. The cover illustration is by David Simonds.

Our thanks go to the interviewees for their time and insights, and to the IMF and Asian Development Bank for permission to reproduce certain charts and tables herein.

Executive summary

This report, sponsored by FedEx, assesses the challenges and opportunities facing small and medium-sized enterprises (SMEs) in Asia, and China in particular, as the world emerges from a catastrophic recession. The fate of SMEs is particularly crucial since they account for the bulk of employment in many of the region's economies and are the cornerstone of Asia's entrepreneurial dynamism. They have been hit disproportionately hard by the global recession of recent months, particularly those companies reliant on exports, but they have shown a resilience and flexibility that bodes well for their ability to capitalise on the region's unexpectedly rapid recovery.

Based on interviews in mid-2009 with corporate officers at SMEs and regional experts, and a review of recent studies published by authorities such as the IMF, the Asian Development Bank (ADB) and national governments, *Towards the recovery: challenges and opportunities facing Asia's SMEs* assesses how such businesses are coping with the crisis. The report also examines how SMEs stand to benefit from two new and interlocking dynamics within the economies of the Asia-Pacific region. The first is the need to rebalance these economies away from a reliance on exports to developed markets in the West, and towards domestic demand. The second is the increasing importance of intra-regional trade, by which mechanism SMEs in smaller nations may take advantage of the rebalancing of the region's giant economies, namely China and India. The report's key findings include:

- **The times are tough, but Asia's SMEs are tougher—and they are in the right region to take advantage of the upturn.** Asia's SMEs have faced a multitude of problems in recent months: a severe squeeze in financing, tumbling orders, diminishing cashflow and rising inventory costs. But some think the severe competition (at least among Chinese export-oriented manufacturers) and a "cost-control culture" have helped them develop resilience in adversity. On a macroeconomic level, they are well positioned to take advantage of the region's surprisingly rapid growth.

- **Cost control and inventory management are still crucial to survival.** Although the region is recovering quickly, many SMEs are still in crisis mode and are focusing on cash-flow protection and strategic reassessment. Cost control, always important for small companies, has become crucial, as has inventory management (for example shifting to make-to-order production from stockpiling). The prompt collection of accounts receivable is also a priority—while quality control is gaining increased scrutiny to ensure clients have no excuse to delay or avoid payment.

- **SMEs could benefit from a rebalancing of Asia's largest economies...** Given the weakness of Western markets, Asian SMEs, many of which are cogs in a global supply chain, would benefit from a new source of final demand within the region. There are signs that China may be able to provide this, as its middle class becomes richer and policymakers seek to rebalance its economy away from a reliance on exports and towards domestic demand. If this trend is sustainable (rather than just a result of massive fiscal stimulus in recent months) it could create a virtuous circle benefiting Asian exporters. Indeed, with

Western consumers unlikely to return swiftly to pre-crisis levels of spending, some larger export-oriented SMEs are asking whether a strategy focusing on domestic markets—or at least reducing their reliance on consumers in the US and Europe—is preferable.

- **...but accessing domestic markets may not be easy.** Reshaping SMEs' corporate strategy to reduce reliance on final demand in the West is not necessarily easy. In China, for example, stiff competition, very diverse internal markets, and the high costs of brand-building and product differentiation may make entering the market an unrealistic proposition for some export-focused SMEs. Indeed, some have decided against this strategy and are waiting instead for demand in the West to recover.

- **A new intra-regional trade dynamic could help SMEs...** If Asia's larger economies do become sources of final demand, this will help drive intra-regional trade. It is already happening to some extent: the proportion of Asia's trade within the region has been steadily rising over past two decades. The proliferation of free-trade agreements (FTAs) in Asia is testament to policymakers' commitment to this goal. But do they benefit SMEs? Those that already have crossborder business within Asia generally regard such agreements positively—and are hopeful that the China-ASEAN FTA, which came into effect in 2010, will be beneficial.

- **...but they need more information to take advantage of FTAs.** While tariff reductions through FTAs are better than nothing, the complexity of overlapping deals (contributing to the "noodle bowl"-like complexity of Asian trade links) is a hindrance to more comprehensive global agreement. Moreover, many SMEs do not use or are not aware of the provisions of many FTAs. One ADB study found that only 22% of Asian companies were exploiting FTA preferences. Better official guidance and information are necessary if SMEs are to take advantages of Asia's evolving trade dynamics.

Introduction

The financial crisis that began on Wall Street in 2008 battered companies around the world through 2009. The shock waves from imploding sub-prime mortgages in the US first hit banks in London, Hong Kong and other financial capitals. But the subsequent credit crunch and global recession have not spared businesses anywhere. In light of the feeble demand and massive job losses in developed countries, the Economist Intelligence Unit estimates the world economy shrank by 2.3% in 2009—a wrenching reversal from 2007 when global GDP grew by 3.8%.

Unsurprisingly, it is the smaller and weaker companies that have struggled the most in this hostile environment. Unlike large corporations, small and medium-sized enterprises (SMEs) have little flexibility to cope with plummeting demand, cancelled orders, scarcer financing and delayed payments. Asian SMEs are no exception, despite their region's dynamism and rapidly improving economic outlook. Right now, crisis management is their top priority, and most are busier with cash-flow protection and strategic reassessment than with a renewed push for growth.

But the future is bright, principally due to an economic recovery in Asia that is envy of the rest of the world. China's economy grew at a sizzling 8.9% in the third quarter of 2009 compared with a year ago, and Chinese demand is lifting other economies in the region. (For instance, South Korea's third-quarter GDP rose 3.2% from the previous three months.) Indeed, such has been the speed of the recovery in Asia, the IMF more than doubled its forecast for economic growth in Asia in 2009 in its latest economic outlook paper, commenting on an "outsized Asian upturn".[1]

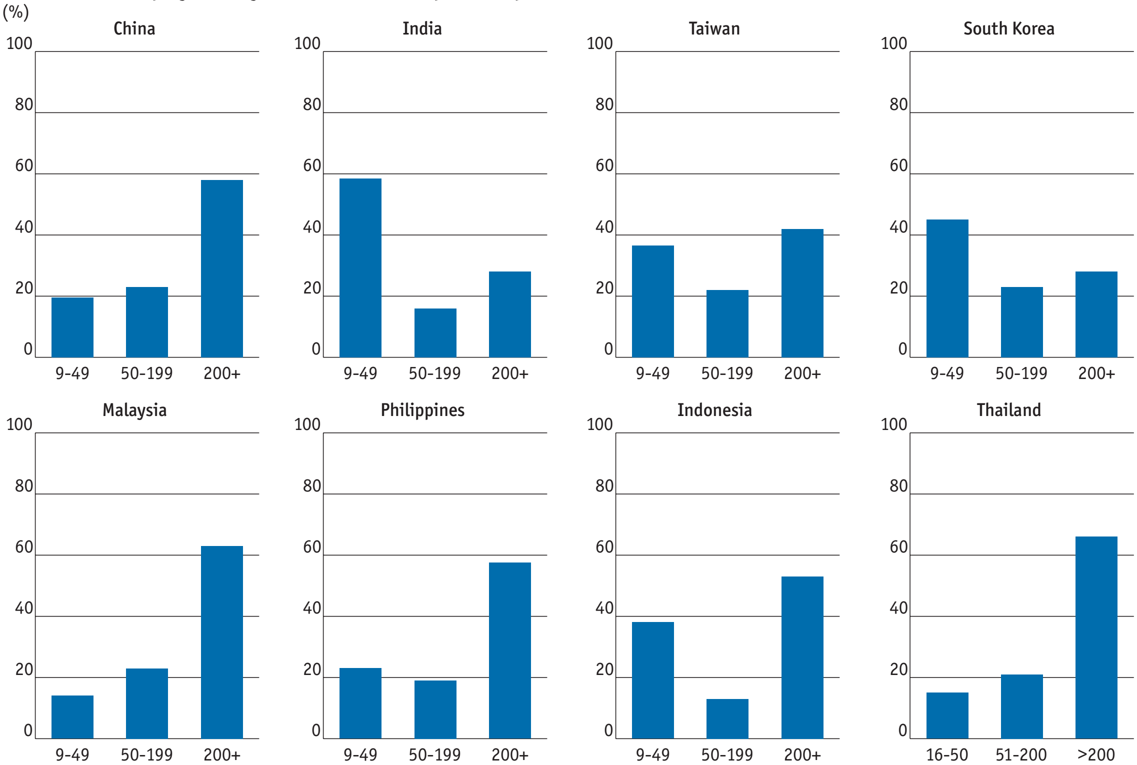
For this briefing paper, *Towards the recovery: Challenges and opportunities facing Asia's SMEs*, FedEx commissioned the Economist Intelligence Unit to assess the impact of the global financial crisis on Asian SMEs, with a focus on Chinese ones, and gauge the outlook for them now that the worst of the crisis is over and Asia's recovery is off to a blazing start. Given that demand within Asia is also likely to be increasingly important for SMEs—and may prompt a strategic shift to focus on local markets, rather than consumers in the West—the paper also examines whether SMEs are taking advantage of any new opportunities created by the multiplying free-trade deals that Asian governments have been pursuing in recent years, and what impact these may have in the post-crisis environment.

Rather than a comprehensive investigation of this vast sector, the purpose of this report is to piece together a preliminary picture of the new landscape Asian SMEs find themselves in, and to speculate about how this may shape their future. The starting point was a dozen interviews in mid-2009 with experts and a selection of SMEs with exposure to international trade operating in China's main manufacturing bases along the eastern and southern coasts. The findings gleaned from these discussions were then supplemented by a review of existing studies published by a variety of sources (for instance, the Chinese government and the Asian Development Bank, or ADB).

But why focus on SMEs in the first place? Does Asia's economic fortune depend on their fate? Yes and no. On the one hand, Asia has its share of big multinational corporations and state-owned behemoths with correspondingly large footprints on the world's industrial map. On the other hand, according to

[1] IMF, *Regional Economic Outlook, Asia and Pacific, Building a Sustained Recovery*, October 2009

Share of total employment by number of workers per enterprise, selected economies
(%)



Source: Asian Development Bank, *Enterprises in Asia: Fostering Dynamism in SMEs*; Key Indicators for Asia and the Pacific 2009, Special Chapter, August 2009

the Asia-Pacific Economic Co-operation (APEC) forum, 95% of businesses in the Asia-Pacific region are SMEs, and they employ 80% of the workforce. Those SMEs towards the medium-sized end of the scale are also among the most dynamic in emerging Asia's export sector (the small ones tend to focus on domestic markets).

Take China. While it is true that large Chinese firms in many strategic industries such as energy, finance and IT are growing more powerful and globally competitive by the year, it is SMEs that still make up most of the country's economic flesh and blood. According to the Chinese government, there were some 42m SMEs (including 4m registered SMEs and 38m one-person businesses)in operation as of 2008, equivalent to 99% of the country's total enterprises and employing 75% of urban dwellers.[2] (By the ADB's somewhat stricter criteria, SMEs account for around 40% of total employment in China.) SMEs also accounted for 58.5% of GDP, 62.3% of exports in value terms and 46.2% of tax revenue.

In the richer economies of greater China they are equally as important. In Taiwan, SMEs account for 98% of enterprises, 77% of employment and 17% of export sales, according to the Ministry of Economic Affairs.[3] In Hong Kong, they account for 98% of businesses and 48% of total employment (excluding civil service positions), according to the government's Trade and Industry Department. Similarly, in developing economies in the region SMEs are crucial. By some estimates Indian SMEs constitute about 80% of the country's industrial enterprises and generate 35% of its exports, employing 70% of the workforce by the ADB's calculation.

[2] These figures are quoted by China's National Development and Reform Commission in unpublished analysis obtained by the EIU. China's official definition of SMEs varies by industry, but encompasses firms with fewer than 3,000 employees and less than Rmb300m (US$44m) in annual turnover. The SMEs interviewed for this paper are based on the official criteria, with between 200 and 2,000 employees and with Rmb30m-300m in annual turnover. (One of the ten firms with 300 employees, however, had annual turnover of Rmb500m in 2008. See p9 for a full list of interviewees.) The Asian Development Bank and other sources use different definitions based on smaller total employee numbers.

[3] Small and Medium Enterprise Administration, *White Paper on Small and Medium Enterprises in Taiwan, 2008*, Taiwan Ministry of Economic Affairs, available at http://www.moeasmea.gov.tw/ct.asp?xItem=7461&ctNode=307&mp=2

APEC says SMEs reflect a country's entrepreneurial vibrancy. If so, Asia has been well served by them. They are a crucial element of Asian economic dynamism. The global financial crisis, however, is testing the resilience of SMEs across the region like never before.

The impact of the financial crisis

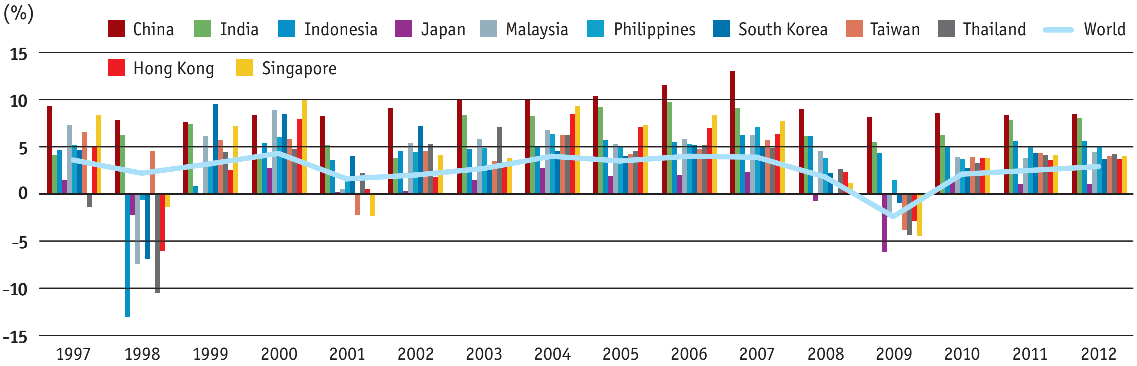
There is little doubt that the global financial crisis threatened (and continues to threaten) the viability of many SMEs. In China, for example, by the end of 2008 more than 100,000 of them had ceased production, according to the Chinese Academy of Social Sciences. As a result, an estimated 20m people had lost their jobs. The downward pressure on SME employment is likely to persist. For instance, the number of people employed in Guangdong province fell by 5% in the first quarter of 2009. And up the coast in Fujian province, Nan Sing Machinery, an industrial knitting-machine maker, told the Economist Intelligence Unit that it has cut its workforce by about 200 people to 600 through attrition since 2007. This was necessitated by a 50% decline in the company's annual sales to Rmb100m in 2008 from Rmb200m a year earlier.

The SME sector has proven to be particularly vulnerable to the current downturn because in many regions in Asia it is populated with low-skilled firms relying on cheap labour to produce export goods. The global economic slump has caused a steep drop in foreign demand, which has triggered a plunge in industrial production in most export-oriented Asian economies. For example, in the first half of 2009, overseas orders for Chinese SMEs' core products such as toys, clothes and furniture fell by 20%-50% year on year; meanwhile, China's overall export-growth rate turned negative for the first time in a decade in December 2008 to -2.8%. Other Asian economies fared just as poorly.

Though the pace of decline is across the region is moderating, as of September 2009 even in China, which has recorded stunning GDP growth figures, exports were still falling at a double-digit pace from the previous year. In Wenzhou in Zhejiang province and Dongguan in Guangdong, where some of the country's biggest concentrations of export-oriented SMEs are found, about 30,000 of them could not adjust to this sudden shift and shut down in late 2008 and early 2009. The National Development and Reform Commission (NDRC, China's de facto economic-planning agency) reckons that, partly because of their greater dependence on foreign markets, Chinese SMEs are in worse trouble today than during the Asian financial crisis of 1997.[4]

[4] China NDRC, unpublished analysis.

GDP, % real change pa



Source: Economist Intelligence Unit

Indeed, a lack of demand may still be the biggest challenge facing export-oriented SMEs. In a survey of 500 Hong Kong companies on mainland China in the second quarter of 2009, 69% replied that weak export demand was a "serious" or "very serious" difficulty facing their operations. The situation had improved only marginally in the third quarter, with 62% maintaining that weak export demand remained a huge problem. Many of the respondents work for export-oriented SMEs in neighbouring Guangdong.[5] And their most important markets are the US and EU—epicentres of the credit crisis where consumers have slashed spending. In this environment of shrinking demand, smaller companies are naturally at a disadvantage to larger ones because buyers are reluctant to place orders with firms whose survival is in doubt, says Billy Wong, a senior economist at the Hong Kong Trade Development Council.

[5] *Trade Quarterly #11*, June 2009, Hong Kong Trade Development Council

The demand shortfall plaguing SMEs is also a reflection of their place in the global supply chain as subcontractors to foreign manufacturers. Zhejiang Success Electronics, an electric jack and cable maker with 300 employees near Wenzhou, saw its exports slide by over 60% in the first half of 2009. This is a critical problem since the company ships about 70% of its output to overseas markets. Alas, when it looked into the reasons for the falling export orders, Zhejiang Success was distraught to find out that demand for its own clients' products, such as computers and cars, also had taken a nosedive.

Chinese SMEs interviewed by Economist Intelligence Unit

	Sector	Employees	2008 sales revenue (Rmb m)	Impact of downturn*	Dependence on trade**	Received aid from government?	Post-recession strategy
Zhejiang Dibei Electrical Machinery	Manufacturing	700	300	Severe	Low	No	Looking for new markets abroad
Zhejiang Success Electronics	Manufacturing	300	30	Severe	High	No	Driving domestic sales a priority
Nan Sing Machinery (Fujian)	Manufacturing	600	100	Severe	High	Yes	Focus on international sales
Pu Cheng Chia Tai Biochemisty (Fujian)	Pharmaceuticals	800	250	Mild	High	No	Drive domestic sales
Dongguan Hongxing Metal Manufactory (Guangdong)	Manufacturing	1000	300	Mild	High	Yes	Increase domestic sales to 50% of revenue (from 20%)
Oleno Underwear (Guangdong)	Manufacturing	2000	90	Mild	Low	No	No change – retain focus on exports
Guangzhou Youlian Leather Products (Guangdong)	Manufacturing	300	100	Mild	Low	No	Stick to domestic markets
Watsonisan Industrial (Guangdong)	Manufacturing	500	200	Mild	High	Yes	No change; costs prohibit focusing on domestic market
Shengnuo Bio-technology Industry (Jiangsu)	Food/healthcare	200	75	Mild	Low	Yes	Penetrate domestic market – Tier II and Tier III cities
Fuzhou Rockchips Electronics (Fujian)	Manufacturing	300	500	Severe	Low	No	Hope to move up value chain to avoid price competition, but still focus on Western mkts

*Severe = sales down more than 30%; mild = sales down less than 30%
**High = exports more than 50% of sales; low = exports less than 50% of sales

Source: Economist Intelligence Unit

Financing problems

This being a credit crisis, SMEs are not immune from financing problems. In fact, for this size of company, the situation has gone from bad to worse. From a bank's perspective, lending smaller amounts to SMEs is always more costly and riskier than lending bigger sums to larger companies. Recognising this, governments around the region—even before the recent recession—had devised policies to improve access to and reduce the cost of financing for SMEs. These included enterprise funds, matching grants and publicly supported SME banks.

The impact of such programmes varied widely across the region, especially where promoting state-owned giants was the focus of economic policy. China's financial system, for example, has never treated SMEs kindly. Since many SMEs are private firms, they suffered from ideological discrimination in the early years of China's market-reform era. The so-called non-state sector did not get the Chinese Communist Party's official sanction until 1997. Even then, state-owned banks that dominate the country's financial system were reluctant to lend to SMEs. These were seen—rightfully—as far riskier than large state-owned enterprises, which carried implicit government guarantees. Chinese SMEs, therefore, were forced to raise money from family members or the black market at exorbitant interest rates.

To redress the situation, the Chinese government in the late 1990s established a nationwide network of state-funded credit-guarantee agencies. These bodies are tasked with the vetting of SMEs' loan requests to banks, and guarantee the repayment of approved applications. But initially, only a tiny fraction of SMEs qualified for the scheme and, at any rate, the banks continued to shun the cumbersome business with small private firms. Even with Chinese monetary policymakers' dramatic easing of interest rates in recent months, many banks are still charging a big premium for loans to SMEs.

For their part, rather than putting up with banks' low credit limits, high fees and thick red tape, many SMEs have preferred to use their own devices to meet their funding needs. Until the global financial crisis erupted, Chinese SMEs typically relied on retained earnings for more than half of their financing and bank loans for only about 20% of it, according to the NDRC. As for raising capital through the issuance of bonds or shares, it has been a practical option for less than 1% of SMEs. Now, though, the crisis has severely disrupted the normal flow of many SMEs' working capital. Unsold goods are piling up as inventories, and delayed payments from business partners are rapidly filling in accounts receivable. The Chinese government fears that this will push even many well-run SMEs to the brink of bankruptcy.[6]

But the SMEs we interviewed in China painted a less alarming picture. Many had substantial credit lines with large state-owned banks. Take Zhejiang Dibei Electrical Machinery Group, a maker of refrigerator-compressor motors based in Shengzhou. The company maintains a relationship with the top five state-owned banks and has access to Rmb100m in total credit, equivalent to one-third of its sales in 2008. Similarly, Nan Sing Machinery secured a revolving bank-credit facility of Rmb60m in late 2007, sensing that an economic crisis was imminent. These companies certainly deserve credit for timely foresight and prudent management.

One SME that admitted to potential funding difficulties was Watsonian Industrial, a manufacturer of plastic products with 500 employees based in Dongguan. Though the company was still using internal capital, as margins were very thin it said it would like to increase its existing bank credit line of Rmb3m. But it could not come up with the sufficient collateral to do so. In a pinch, the company said, it could raise cheap loans outside China through its overseas parent. One hurdle with this option, however, would be obtaining approval from Chinese authorities to bring the money into the country.

[6] NDRC, op. cit.

The official response: policies to help SMEs

Governments across the region—from India to Japan—jumped into action to support SMEs soon after the global crisis hit. The most typical response has been to beef up loan-guarantee schemes. But because the credit crunch made banks extremely risk-averse, more loan-guarantees have not necessarily translated into more loans. Hence, several governments, including those in China, India, the Philippines, Singapore and Thailand, have moved to reduce SMEs' tax burden so as to alleviate the overall financial pressure on them.

This policy convergence is a result of Asian governments' collective experience dealing with the earlier regional financial crisis in 1997-98. According to the ADB, they all took away a number of common lessons. First and foremost, governments were reminded of the key role SMEs play in their countries' economies and development. Not only are SMEs ubiquitous but they are also, by dint of their smaller size, more flexible and adaptable to change than large companies. But simply twisting the arms of bankers to lend more to SMEs has proven to be ineffective, and has often led to capital misallocation. Perhaps this is why few Asian governments have increased state-owned banks' loans specifically earmarked for SMEs this time.[7]

[7] Ying Qian, "SME Financing in the Asia- Pacific Region: Crisis and Countermeasures", Asian Development Bank, June 2009

China has taken both the top-down and bottom-up approaches. Edicts have been handed down by Beijing instructing the five biggest state-owned banks to not let the pace of loans to SMEs fall below the average loan-growth rate, extending tax breaks to SMEs in high-tech industries, increasing export-tax rebates on some goods (notably textiles) and offering Rmb1bn in additional state funding for SME credit-guarantee schemes. Meanwhile, at the local level, some governments such as Guangdong's have set aside billions of renminbi to help local SMEs upgrade their technologies and pursue innovation.

According to several SMEs we interviewed in China, this kind of pragmatic assistance from local governments has been more useful than directives from Beijing. Both Dongguan Hongxing Metal, which makes kitchen and bathroom wares for export, and Watsonian praised municipal officials in Dongguan. They have sponsored SMEs' attendance at domestic and foreign trade shows, even covering the cost of the trips. In addition, they have arranged meetings between SME executives and local bankers in an effort to ease the financing drought. Nan Sing Machinery also reported that local governments in Zhejiang, where many of its textile and clothing customers are based, have offered rebates of Rmb5,000 to encourage them to upgrade to computerised sewing machines from manually operated ones.

Nevertheless, across Asia policies to help SMEs are rarely subjected to rigorous evaluation, meaning their impact is difficult to measure. Experts say the best way for policymakers to help SMEs is to allow them to help themselves. Or as Ying Qian, a principal economist at the ADB, puts it: "Governments should give more flexibility to the market to find its own solutions." For example, in China more substantial land reform would give SMEs better access to capital. How? Currently, the state owns almost all land and prescribes a complex system of land-use rights. This prevents firms from pledging their land-use rights to banks as collateral.

Selected policy measures to assist enterprises

Region/economy	SME loans	Loan guarantees	Tax incentives	Others
East Asia				
China	Five state banks to open special service credit outlets for SMEs in 5 yrs; additional CNY 1bn for SMEs; reserve requirements for banks have been reduced and lending quotas have been increased		Tax rebates for exports; VAT cut by allowing companies to deduct the full cost of capital equipment	
Hong Kong		Expansion of SME Credit Guarantee Scheme to HK$100bn while continuing to provide 70% loan guarantees		
South Korea	Increase loans to SME from US$21.4bn to US$31.4bn	Increase credit guarantee for SME US$35.7bn; and cut interest rates on special loans to SMEs		
Taiwan		Increased donation to SME Credit Guarantee Fund by NT$1bn		NT$200bn to develop competitive industries and NT$42 .7bn to promote employment and provide on-the- job training to workers over 4 years
South-east Asia				
Indonesia	Simplified requirements for lending to SMEs	Direct People's Business Credit Scheme (KUR)		
Malaysia		SME Credit Bureau; US$16bn stimulus package that focused on job creation and credit guarantees to SMEs		
Philippines			Exempt from income tax, import duty, for 6 years	
Singapore	S$1.5bn package that improves business access to credit and trade finance scheme to help exporters obtain loans and insurance		S$1.8bn for tax measures & grants to improve cash flow and competitiveness of firms	
Thailand		Portfolio Guarantee Scheme for SMEs	Enacted tax measures to promote SMEs in January 2009; extension of tax allowance for mortgage interest payments and property tax breaks for companies	

Selected policy measures to assist enterprises

Region/economy	SME loans	Loan guarantees	Tax incentives	Others
South Asia				
Bangladesh	Continue current thrust of providing adequate credit support to agriculture, SMEs, and other productive sectors that are primary sources of job expansion			
India	Stimulus package focusing on access to credit, and to protect employment in labor-intensive industries and government infrastructure; provided shipment credit for labor-intensive exports with interest subvention	Credit Guarantees; Fund Trust for Micro and Small Enterprises	Duty reductions/ eliminations and service tax refunds	Additional allocation for export incentive schemes
Pakistan	Subsidized interest rates; provided credit finance to exporters by enhancing bank limits under the Export Finance Schemes and Long-term Financing Facility by Rs35bn	Credit Guarantee Agency; Credit Information Center		
Sri Lanka				Stimulus package valued at Rs16bn which includes cuts in fuel prices and incentives to tea, rubber, cinnamon, and garments export sectors

Source: Asian Development Bank, *Enterprises in Asia: Fostering Dynamism in SMEs*; Key Indicators for Asia and the Pacific 2009, Special Chapter, August 2009

The operational response: strength in flexibility

Many SMEs live in fear of failure. Unlike large companies, their margin of error is razor thin when the business environment turns for the worse. SMEs everywhere are acutely aware that survival depends on getting right a few fundamental aspects of their operations. To ride out the current downturn, nearly all of the companies the Economist Intelligence Unit interviewed said this has meant that they had to redouble their efforts on cash and inventory management. Many other Asian SMEs no doubt can relate.

When the financial crisis hit, several of the SMEs we interviewed noticed that their clients wanted to delay payments. Though maintaining good customer relationships is important, for any company getting paid on time takes precedence. For example, Pu Cheng Chia Tai Biochemistry, a Fujian-based drug-maker, stepped up collection of accounts receivable and tightened credit terms to clients even at the risk of incurring a short-term drop in sales. “We have to make sure we’re not squeezed for cash,” says the company’s CFO. Meanwhile, Zhejiang Success Electronics says it is now paying more attention to the quality of its products, because “in a tough time, you don’t want your clients to find an excuse and not pay you”, according to the head of its finance department.

As for inventory management, SMEs that rely on commodities as key inputs are finding it especially difficult to cope with volatile prices of raw materials. In the second half of 2008 Zhejiang Dibei amassed a large stockpile of copper and other inventories amid rapidly increasing prices. But the situation reversed towards the end of the year, and the company had to swallow huge losses on its accumulated inventory. With commodity prices still unpredictable, Dibei admitted that it was tough to find a solution to the problem.

By contrast, Nan Sing Machinery simply stopped stockpiling aluminium and copper when falling sales in early 2009 started to create excess inventories. At the same time, the company put its manufacturing on a make-to-order footing, producing its knitting machines only when the orders came in. This shift shielded the company from incurring further losses from an inventory build-up.

Such decisive actions illustrate an ingrained cost-control mentality, which has been shaped by SMEs’ constant exposure to fierce competition. And the hard time they have in accessing capital even in normal times makes smaller companies that much more resourceful in navigating through a crisis like the current one. Another hallmark of SMEs is their flexibility and readiness to change with prevailing conditions. In the words of Dongguan Hongxing Metal’s CFO, “it’s the culture of perseverance that helps the company survive a downturn”. One might add that the times are tough, but Asian SMEs are even tougher.

The strategic response: growth at home

The future of Asian SMEs is hardly all doom and gloom. On the contrary, the profile of the sector as a whole should continue to rise. For instance, as market roots burrow ever deeper into the Chinese economy, the state sector will naturally shrink and more SMEs will sprout up to fill the gap. Moreover, the urbanisation of China will continue unabated for years to come, and millions of farmers who arrive in the cities as migrant workers will take jobs with SMEs. The same thing is happening all across Asia. But in China, these trends are so powerful that they are remaking the country's economy at a much more dizzying rate, according to Mr Qian of the ADB.

To be sure, many uncompetitive SMEs in Asia will go out of business and their employees will lose jobs. Many SMEs are one-trick ponies that are not good at taking up other skills. But as the jaded ones exit the stage, other breeds of SMEs with new talents will emerge to seize market opportunities. It is no coincidence that three of the SMEs the Economist Intelligence Unit interviewed saw a silver lining in the current crisis from the fact that some of their weaker competitors had been forced out. According to Guangdong-based Oleno Underwear, fewer industry players means a sounder foundation for its own future growth through market-share expansion, even though it suffered a double-digit sales decline in 2009 compared with 2008.

As in previous crises, the great credit crunch is forcing companies everywhere to rethink their existing strategies. And for Asia's too-export-dependent SMEs, this may be the perfect time to retool their businesses to seize the vast opportunities available in their own backyard—which, as already noted, is growing as if the global financial crisis never happened. This focus on the domestic market has been the main policy response of the Chinese government—although many foreign critics would contend that China is still too reliant on exports. In the past few months officials have unleashed a torrent of measures—including handing out consumption vouchers to the poor, giving tax incentives for car purchases and issuing "buy Chinese" guidelines to government agencies—designed to boost China's domestic demand.

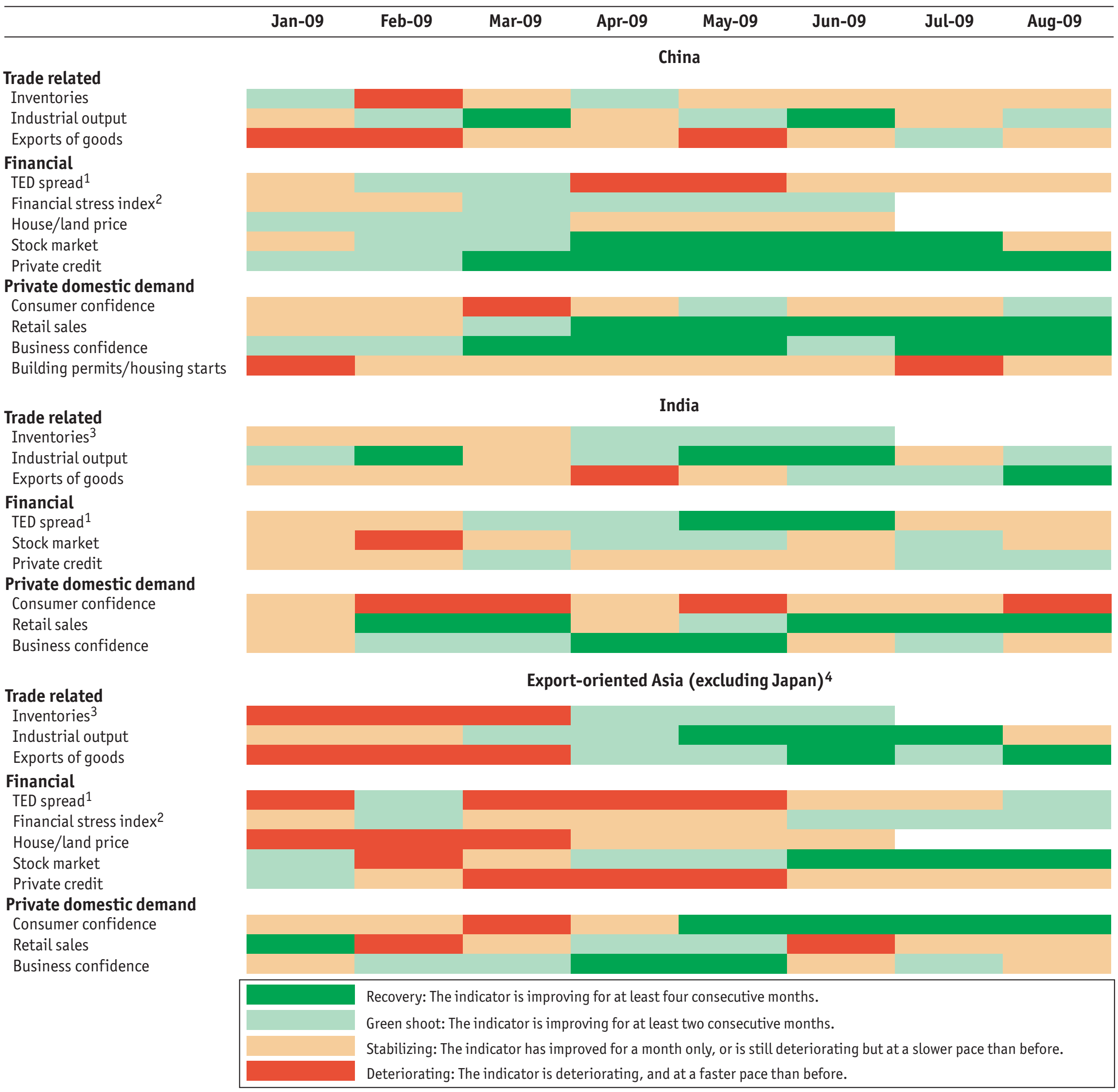
Above all, the gargantuan Rmb4trn stimulus plan that the Chinese government unveiled in late 2008 underscored Chinese leaders' determination to ensure continued economic growth at any cost. The bulk of the stimulus spending, however, is on large civil-infrastructure projects such as construction of railroads, highways, airports and power plants. This will undoubtedly generate spill-over effects across the economy. The extra liquidity flowing through the economy has buoyed the country's stock and property markets. As people feel flush again, Guangzhou Youlian Leather Products, for one, believes it will sell more handbags and other leather goods it makes. The company's sales in the first half of 2009 rose by more than 10% year on year, which its CFO attributes to just such a wealth effect.

To be sure, direct benefits to SMEs from the stimulus package are likely to be minimal and limited to those in the cement, steel or other infrastructure-related sectors. (Six of the ten firms we interviewed said they felt no benefit from the stimulus.) But many will have been encouraged by data that showed China's retail sales grew by 15.1% year on year in the first three quarters of 2009, almost as fast as before the financial crisis began. While this may also just be a result of stimulus-related spending, the growing spending power of the urban middle class—and the benefits of more government spending on healthcare and pensions in rural regions—is undeniable.

Moreover, if China's domestic demand does emerge as a new engine of growth, it will benefit the whole of Asia, according to the ADB.[8] The Chinese economy can then anchor a new regionwide trade dynamic (examined in more detail in the next section), not merely as an assembly point for exports to Western

[8] Asian Development Bank, *Enterprises in Asia: Fostering Dynamism in SMEs*; Key Indicators for Asia and the Pacific 2009, Special Chapter, August 2009

Asia: Growth momentum (selected economies)



[1] Three-month (or short-term) money market rate minus equivalent T-bill rate
[2] See Balakrishnan, Ravi, Stephan Danninger, Selim Elekdag, and Irina Tytell, 2009, "How Linkages Fuel the Fire: The Transmission of Financial Stress from Advanced to Emerging Economies," Chapter 4 in World Economic Outlook (Washington, International Monetary Fund, October 2009).The index comprises seven variables capturing developments in the banking sector, the securities markets, and the foreign exchange markets
[3] Based on quarterly data
[4] Hong Kong, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, Vietnam

Source: IMF, *Regional Economic Outlook, Asia and Pacific, Building a Sustained Recovery,* October 2009. Reproduced with permission.

markets but as a final destination for other Asian countries' goods. This will, in turn, set off a virtuous circle of stronger and more dynamic Asian SMEs, which will help create in their respective countries a bigger middle class who, after all, will form the backbone of a growing market for their products and services.

Indeed, governments around the region are following China's lead in attempting to rebalance their economies, recognising that exports are unlikely to recover their pre-crisis rate of expansion any time soon. Some economies, such as Hong Kong and Singapore (where exports are the equivalent of around 200% of GDP) will always be globally exposed. However, other big economies in the region, especially India and Indonesia, which are less exposed to global trade, have the potential to become an important source of intra-regional demand. If they do so, the regions' SMEs stand to benefit. And there are encouraging signs that private domestic demand in Asia is recovering (as the chart on page 16 demonstrates).[9] Small wonder, then, that Asian SMEs are the most optimistic among their peers worldwide. In a survey of 730 SMEs by the Economist Intelligence Unit in August 2009, 66% of respondents from the Asia-Pacific region expected revenue growth over the next two years—compared to just 46% in eastern Europe, the most pessimistic region.[10]

Has this change of focus at the macroeconomic level led to a strategic shift among heavily export-dependent SMEs in Asia? In some cases the reality that export volumes have been permanently shrunk by the recent recession has forced a rethink. SMEs like Zhejiang Success and Dongguan Hongxing Metal say they understand the importance of driving domestic sales and are actively pursuing them. They are hoping to emulate the success of fellow SMEs which have thrived by catering to domestic customers. Among the companies we interviewed, Shengnuo Bio-technology Industry in Nanjing stands out as an exemplary case. The firm manufactures health products, such as vitamins, targeted at older Chinese. Its sales briefly dipped in the first quarter of 2009 but since then have recovered. The company attributes its recent performance to its strong brand recognition among the Chinese public and its reputation for high quality. And with more Chinese of every stripe becoming health conscious, Shengnuo is confident that its domestic-business prospects remain bright.

Still, experts caution against unrealistic expectations when shifting focus from the export to the domestic market. China's internal markets are notoriously fragmented, with huge regional differences in consumer tastes and distribution channels. Many sectors are also overcrowded with too many players. So in the end both Chinese and Asian SMEs may find that expanding in China is almost as hard as breaking into new foreign markets. That is just the conclusion Watsonian reached after a careful study of its chances in the domestic market. The company realised that the upfront marketing cost needed to differentiate itself from others would be too high—especially at a time when its cash flow is already very tight. It was also discouraged by the fierce competition in the plastics sector. Even if government initiatives, such as the "buy China" campaign, prove to be effective, the benefits would be overwhelmed by potential losses accruing from a price war, says a senior company executive.

[9] See also *Asia And Pacific Region—Outlook And Challenges*, IMF, October 4th 2009

[10] *Surviving the drought: Access to finance among small and medium-sized enterprises*, Economist Intelligence Unit, October 2009

A new trade dynamic?

As already mentioned, trade has been the lifeline for many Asian companies. But in 2008 it turned the tables on them. Though Asian financial institutions were largely uncontaminated by Wall Street-made toxic assets that triggered the global credit crunch, most Asian economies crashed just the same because of a sudden drop in demand for their exports in the crisis-hit West. Compared to the plunging orders, any rise in protectionist sentiment around the world has so far been insignificant. None of the SMEs the Economist Intelligence Unit interviewed has felt any impact from anti-trade sentiments or barriers in overseas markets. For example, Dongguan Hongxing Metal believes protectionism is not a worry as long as it maintains good relationships with foreign buyers.

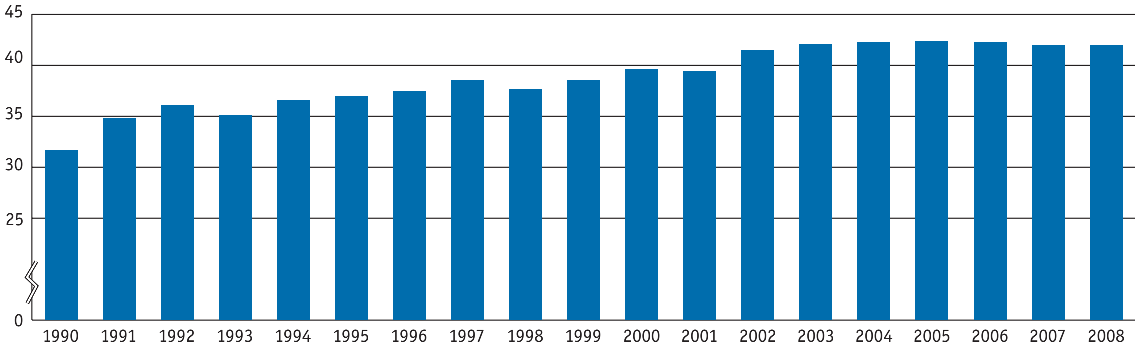
Now, though, restocking of inventories in the West is fuelling a recovery in Asian exports. But much of the recent impetus for purchases in the US and Europe came from massive fiscal-stimulus plans and one-off government-incentive programmes (eg, the cash-for-clunkers initiative to help Detroit carmakers).

That means Asian countries must look for alternative sources of growth. Stimulating domestic demand within the region is one option, and all eyes are on China's current effort to do so. Linked to this is an effort to promote more trade with each other, rather than to keep relying on demand from Western economies. In other words, Asian economies should aspire to become more like those of the European Union, where about two-thirds of its trade takes place within the region. This makes good political sense, too, since it is unlikely that Chinese or any other Asian economies will be able or be allowed by their Western trade partners to export their way to recovery as they did following the Asian financial crisis a decade earlier. China, by contrast, seems to welcome Asian trade, judging by its enthusiasm for pursuing free-trade agreements (FTAs) with its neighbours.

Intra-regional trade among Asian countries, in fact, has risen considerably in recent years. Between 1990 and 2008 the share of intra-regional trade for East and South-east Asian countries (excluding Japan) increased some ten percentage points from 31.7% to 42% of their total trade, notes the ADB.[11]

[11] *Asian Development Outlook 2009 Update*, Asian Development Bank, September 2009

Intraregional trade, East and South-east Asia* (% of total trade)



* East Asia = China, Hong Kong, South Korea, Taiwan; South-east Asia = Brunei, Cambodia, Indonesia, Laos, Malaysia, Mongolia, Myanmar, Philippines, Singapore, Thailand, Vietnam

Source: *Asian Development Outlook 2009 Update*, Asian Development Bank, September 2009

But look more closely at the underlying trade patterns, and there is less to this expansion than the headline numbers would suggest.

Much of Asia's current intra-regional trade reflects different countries' specialisation in different segments of one long supply chain that snakes across national borders. For example, raw materials from South-east Asian countries are first shipped to component makers in Taiwan or South Korea, who then send on these ready-made parts for final assembly in China's low-cost factories. The bulk of the finished products, from toys to flat-panel TVs, are ultimately destined for store shelves in Los Angeles or London.

The problem with this kind of intra-regional trade is that it does not insulate Asia from demand cycles outside the region. For intra-regional trade to serve as a truly self-powered engine of growth, Asian countries need to trade with each other in more finished products. And for that to happen, they need to enlarge domestic demand for such goods. Encouragingly, there are signs that "a secular shift" is underway in China's imports from components to finished goods, according to the ADB. "[China] is becoming more of a consumer and less of an assembler," it notes in a recent report.[12] And although the shift is less obvious elsewhere, Asia's other major economies—such as India—have the potential to act as engines of growth for developing economies in the region. This ties in nicely with the realisation across the region that the export-to-the-West growth model is unsustainable. As the IMF puts it, "[F]or Asia to retain its strong growth momentum, it needs to shift the drivers of recovery from an export engine more into domestic demand within Asia."[13]

In fact, though, both trade within the region and with other regions is vital for Asian countries. This is why they must continue to pursue trade liberalisation. The World Bank's ratings of Asian countries' trade facilitation—which measure performance in areas such as efficiency of customs, transportation costs and timeliness of shipment—show that, while generally good, there is room for improvement. On a rising scale of 1 to 5, the majority of the ten Asian countries (Taiwan, South Korea, Malaysia, China, Thailand and Indonesia) examined scored between 3.64 and 3.01. Only two scored higher than 4 (Singapore and Japan).

One popular policy initiative among Asian countries in recent years has been FTAs. As of mid-2009

[12] Ibid.

[13] IMF, *Regional Economic Outlook, Asia and Pacific, Building a Sustained Recovery*, October 2009

China as final consumer?
Trade balance with developing Asian economies, US$bn, 1996 and 2008

	Total trade		Basic products		Construction materials		Parts and components		Final goods	
	1996	2008	1996	2008	1996	2008	1996	2008	1996	2008
East and South-east Asia[1]	7.41	58.63	2.30	-14.84	0.86	3.42	-7.57	-5.64	11.82	75.65
High-income East and South-east Asia[2]	8.09	74.34	5.76	4.57	0.52	2.15	-7.99	-12.02	9.80	79.65
Other East and South-east Asia[3]	-0.68	-15.71	-3.46	-19.41	0.34	1.27	0.42	6.38	2.02	-4.00
Non-East and South-east Asia[4]	0.82	38.29	-0.60	-18.01	0.15	0.63	0.41	3.62	0.60	41.44

Note:
1 - see note to table on p18
2 - Hong Kong, Singapore, South Korea, Taiwan
3 - Brunei, Cambodia, Indonesia, Laos, Malaysia, Mongolia, Myanmar, Philippines, Thailand, Vietnam
4 - Rest of Asia excluding 1

Source: *Asian Development Outlook 2009 Update*, Asian Development Bank, September 2009

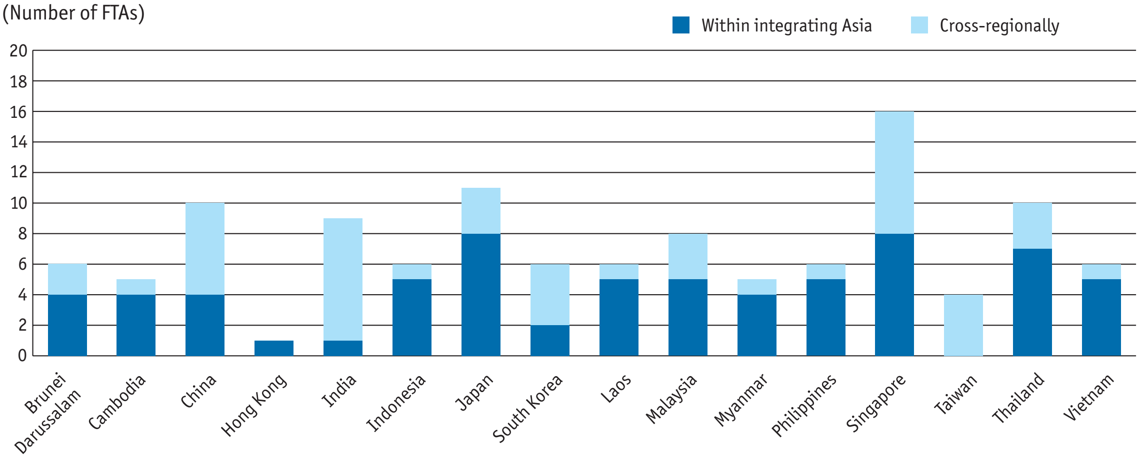
they had concluded 54 FTAs among themselves and with countries outside the region, and many more are currently under negotiation. And the Association of South-East Asian Nations (ASEAN) is emerging as the hub of intra-Asian FTAs, having concluded pacts with China, Japan and South Korea.

On January 1st 2010 the China-ASEAN Free Trade Area (CAFTA) went into effect. This created a common market of some 1.7bn people. Under the agreement, 90% of the goods traded between China and ASEAN's six richest member countries now enjoy zero tariffs. Many of the Chinese SMEs we interviewed generally regard FTAs as a positive development, and say they will benefit directly from CAFTA. Nan Sing Machinery, which ships 40% of its exports within Asia, believe its products will become even more cost-competitive in ASEAN against Japanese products. And both Oleno Underwear and Watsonian Industrial said they have already seen more business in Singapore, with which China implemented a bilateral FTA as of January 1st 2009. Though more curious than converted, half of the Chinese SMEs we interviewed would like to see China conclude more FTAs, including with Western countries.

But some economists are concerned that these criss-crossing FTAs add up to a mere "noodle bowl" of chaotic and potentially trade-distorting schemes. Moreover, the ADB says few Asian companies know how to take advantage of all the benefits contained in an FTA, such as preferential tariffs, easier market access and other business opportunities. In a survey of 609 East Asian firms in 2007-08, it found that only 22% of them were exploiting FTA preferences.[14] Significantly, the survey results indicate that many SMEs with their limited resources to handle multiple tariff schedules and document requirements do not yet know how to use FTA provisions. From the SMEs' standpoint, this suggests that, at a minimum, they could use much more official guidance and information, and, ideally, the conclusion of a regionwide FTA or a comprehensive trade-liberalisation agreement under the aegis of the WTO would be more helpful than a proliferation of bilateral trade deals. Nonetheless, in the meantime, trade preferences offered by FTAs—especially among Asian countries—clearly represent a major opportunity for SMEs in the region to grow their crossborder businesses.

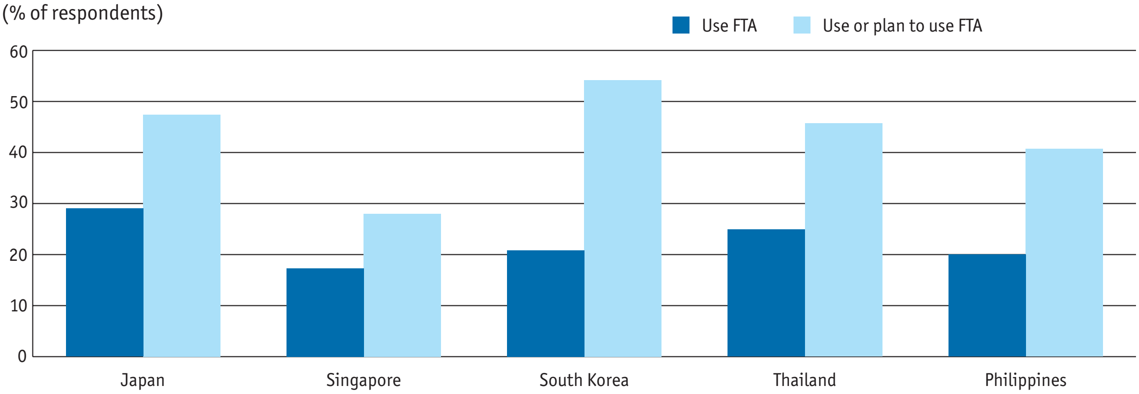
[14] Masahiro Kawai and Ganeshan Wignaraja, "Asian FTAs: Trends and Challenges", *ADBI Working Paper Series*, Asian Development Bank Institute, August 2009

Geographical orientation and share of concluded FTAs in integrating Asia-FTAs within integrating Asia and cross-regionally
(Number of FTAs)



Source: See sidenote 14, above

Utilisation of FTA preferences, selected economies
(% of respondents)

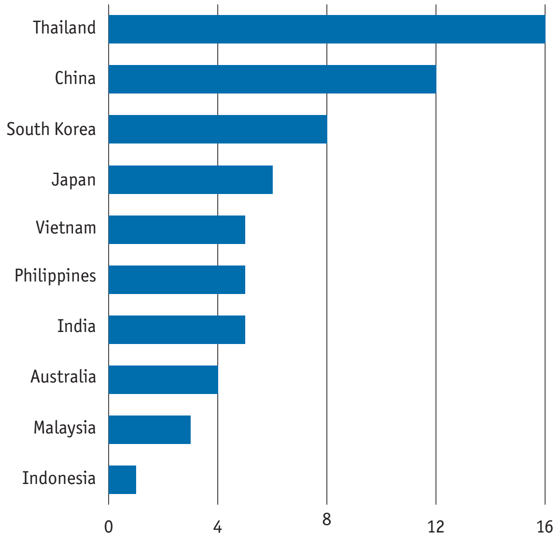


Source: See sidenote 14 on p20

Conclusion

For Asian SMEs, the coming months certainly look more encouraging for business prospects than the past months have been. The Economist Intelligence Unit's latest forecast is that Asia (excluding Japan but including Australia) will manage to turn in positive growth of 6.5% this year after expanding 4.2% in 2009. As the world economy as a whole shrunk 2.3% last year and will grow just 2.6% in 2010, Asia is clearly a good place to be.

Spending for recovery
(Fiscal stimulus as % of GDP)



Source: Economist Intelligence Unit

But how sustainable is Asia's better-than-expected growth? The IMF, for one, has warned that Asia cannot count on a sustained pick-up in external demand this year or even in 2011 for a strong export-led recovery. As long as household debts and unemployment rates remain elevated, Western consumers are likely to keep their spending in check. Even within Asia, the boost from government stimulus packages has been critical in marinating the growth momentum. Relative to GDP, fiscal expansions in China, Japan, South Korea and Thailand have all been greater than in the US. As the effects of these emergency pump-priming fades and governments' attention shifts to restoring the budget balance, private-sector demand in Asian countries must take the lead—or growth will falter. Encouragingly, there are signs that domestic demand in China is emerging as a driver of growth within the region, giving trade-dependent SMEs across Asia the opportunity to diversify their markets away from the still vulnerable economies of the US and Europe.

In any event, for many Asian SMEs that are still standing, more economic uncertainty should not faze them too much. If they have managed to survive this long, it is thanks to their proven agility and resourcefulness. While continued efforts to improve operational efficiency remain important, for SMEs' future business success seizing new opportunities arising in the post-crisis landscape—such as burgeoning demand from China's domestic market and preferential trade schemes from FTAs—will be equally vital. And in so doing, the best of these SMEs may emerge as Asia's next corporate stars.

Cover image - David Simonds

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