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Trade and Investment Liberalization Effects on SME Development: A literature Review and a Case Study of Indonesia

By

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Executive Summary

The impact of international trade and investment policy reforms on the Indonesian economy, focusing on economic growth and development of domestic manufacturing industry has been studied extensively enough. However, the implication of these trade and investment policy reforms on the growth of small and medium enterprises (SMEs) in Indonesia remains an under-researched area of both the literature on SMEs in Indonesia and in general. This study, thus, attempts to make a contribution to fill this gap by examining the impact of international trade and investment policy reforms, particularly in the post-crisis period on the growth of SMEs in Indonesia.

As this research seeks to bring to the fore benefits that have been or may be derived for SMEs from international trade and investment liberalization in Indonesia, it has three main questions: (1). how international trade and investment policy reforms affect local SMEs; (2) has growth of exports of SMEs accelerated since the reforms; and (3) does investment liberalization generate more subcontracting between local SMEs and FDI.?

The research process has three subsequent phases: (1) In-depth literature survey on the effects of macroeconomic policies, especially international trade and investment, on SMEs; (2) Secondary data analysis on the performance of SMEs; (3) Primary data analysis. With respect to the third phase, primary data were collected through a survey. The location of the survey was Tegal metal working industry in Central Java, since many SMEs (though not the majority) in this cluster have been involved in subcontracting linkages with foreign firms, mainly Japanese, since 1980s.

This study comes with two important findings. First, although many SMEs may have been lost their markets, in overall, the reforms have not affected SMEs negatively. After a slightly decline in 1998 as a consequence of the economic crisis, the number of SMEs kept growing since then. These enterprises have managed not only to survive but also to increase their output. Their export and their share in total private investment also increase on average per year. Second, subcontracting linkages between FDI and local SMEs still remain low

One important policy recommendation of this study is that, given in fact that the majority (if not all) of SMEs (especially SEs and MIEs) in Indonesia are not ready yet to compete due to their weaknesses in many areas including technology, human resource, capital, marketing knowledge, global networks, etc., in order to make local SMEs to gain more benefits than to experience losses from the trade and investment reforms in the long run, the government should seriously support the capacity building in these enterprises, especially in the areas of technology and skills.

I. Introduction

International trade and investment policy have undergone fundamental change in Indonesia over the past two decades. Significant trade liberalization began in 1986 and since 1994 Indonesia has significantly reduced its applied MNF tariffs from an unweighted average of about 20% in 1994 to 9.5% in 1998. In 1998, tariffs on food items were reduced to a maximum of 5%. Besides tariffs, Indonesia has undertaken to remove all non-tariff barriers and export restrictions. Since the beginning of the 1997/98 Asian financial crisis, Indonesia has also deregulated its trade regime in the main agricultural commodities (except rice, for social reasons), terminated production and trade monopolies in certain intermediate industries (cement, plywood, rattan) and reduced export taxes on wood.

Parallel to international trade reform were reforms in the treatment of foreign investment, with ownership restrictions all but eliminated by 1995. The opening up of nearly all industries to foreign direct investment (FDI) between 1993 and 1995 helped attract large amounts of FDI. Based on the approval FDI data from the National Investment Coordinating Board (BKPM), in 1995 new approval FDI (in project units) increased by almost 30% from 1993 data, whereas in 1993 the increase was about 10% from 1990 data. In 2004, the government has established an Investment Policy Reform Initiative having as its objective the encouragement and facilitation of private sector investment through reform and implementation of transparent, predictable, market oriented policies applied equally to both foreign and domestic investors. In this the Government has recently adopted major policy changes, including the introduction of new investment law. As will be discussed in Chapter III (Box 3), this new law incorporates market oriented principles of investment policy and establishes basic guarantees such as equal treatment of Indonesian and foreign investors whenever possible, protection against expropriation of investment. Investors are permitted to invest in any sector of the economy except in activities, which are listed on "Negative List". There are no restrictions on the size of the investment, the source of funds or whether the products are destined for export or for the domestic market.

The impact of international trade and investment policy reforms on the Indonesian economy, focusing on economic growth and development of domestic manufacturing industry has been studied extensively enough. However, the implication of these trade and investment policy reforms on the growth of small and medium enterprises (SMEs) in Indonesia remains an under-researched area of both the literature on SMEs in Indonesia and in general. This study, thus, contributes to filling this gap by examining the impact of international trade and investment policy reforms, particularly in the post-crisis period on the growth of SMEs in Indonesia. In particular, answers to the following three questions were sought: (1) How does international trade and investment policy reforms affect local SMEs? (2) Has growth of SMEs exports accelerated since the reforms? and (3) Does investment liberalization generate more subcontracting opportunites for local SMEs?

Following a comprehensive review of the available literature on the effects of international trade and investment policy reforms in section II, overviews of International trade and investment reforms in Indonesia and of the development of Indonesian SMEs are given in, respectively, sections III and IV. Effects of the reforms on Indonesian SMEs are examined in section V, complemented by findings from a cased study of a cluster of Indonesian manufacturing SMEs in section VI. Conclusions and policy recommendations are in section VII..

II. Literature Review

The Asia-Pacific region provides evidence of the benefits of external trade (export and import) and investment liberalization policies. With the continued growth in external trade and inflow of foreign direct investment (FDI), the region continues to generate the highest rates of economic growth in the world, which has seen an average reduction in poverty of about 12.5 percent in this region in early 2000 as compared to early 1990s. Through external trade and FDI, the region will be further integrated into the global economy and will gain more benefits of it (Bonapace, 2005).

No doubt that the surge in exports of manufactured goods from Indonesia that occurred in the late1980s until the mid-1990s coincided with a sharp increase in FDI in the country. Several previous studies have indicated that multinational enterprises (MNEs) were the source of a large portion of the surge of manufactured exports and also made important contributions to changes in export composition of Indonesia.[1]Trade policies in Indonesia also played an important role in the growth of the country's manufactured exports and the change in composition of manufactured exports. James and Ramstetter (2005) emphasized how low protection which adopted by the Indonesian government in the 1980s with respect to certain industries was a key facilitator of rapid export growth of those industries. Despite a slowdown in export growth that began in 1996 and continued into 1998 with the Asian financial crisis, Indonesia did not reverse its export-oriented trade liberalizing reforms. After the crisis, many MNEs expanded their operations in Indonesia (Takii and Ramstetter 2004).

II.1. Effects of International Trade Reform on SMEs

It is generally believed that trade liberalization should beneficial for domestic economy as well as the world as a whole. At an aggregate level, the channels through which trade reform could bring benefits are broadly the followings: improved resource allocation; access to better technologies, inputs and intermediate goods; economies of scale and scope; greater domestic competition; availability of favorable growth externalities like transfer of know-how and many others.[2]

Until quite recently, more attention has been given to macroeconomic effects of international trade reforms.[3]There is now a small but growing empirical literature on the effects of international trade liberalization at a disaggregate level. Theoretically, reform towards international trade liberalization could affect (positively or negatively) individual local firms in four major ways:

- by increasing competition: lower import tariffs, quotas and other non-tariff barriers have the effect of increasing foreign competition in the domestic market, and this is expected to push inefficient/unproductive local firms to try to improve their productivity by eliminating waste, exploiting external economies of scale and scope, and adopting more innovative technologies, or to shut down. Openness of an economy to international trade is also seen as increasing plant size (i.e. scale efficiency), as local firms adopt efficient technologies, management, organization, and methods of production;[4]

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[1] See for instance, James and Ramstetter (1997) and Ramstetter (1997, 1998, 1999a, 1999b).

[2] For more development in this sense, see further among others, Falvey and Dong Kim (1992), and Pack (1993).

[3] Some of the best known are: Krueger (1978), Dollar (1992), and Kruger *et al*. (2000).

[4] This is in line with general theory in which size is predicted to affect export performance of firms positively. The new international trade theory posits a positive impact of market size in view of economies of scale. It argues that the scale economy provides costs advantages in production, R&D and marketing efforts. See for instance, Tybout (1992) and

- by lowering production costs due to cheaper imported inputs: local firms benefit from lower input costs, thereby allowing them to compete more effectively in both domestic markets against imports and in export markets;
- by increasing export opportunities: opening up to international competition will not only induce increased efficiency in domestic firms but it will also stimulate their exports;[5]
- by reducing availability of local inputs: eliminating export restrictions on unprocessed raw materials will increase export of the items at the cost of local industries.

Thus, in the case of SMEs, it can be expected that international trade liberalization that increase foreign competition in domestic market will hurt some inefficient or uncompetitive SMEs, while benefit other efficient or competitive SMEs. The efficiency effects of foreign trade liberalization may be observed in an increase in average plant size among SMEs and (presumably) lower average costs. The international literature on the effect of foreign trade policy on SMEs presents, however, some surprising and quite important findings. The seminal work of Tybout (2000) on the micro dynamic effects of international trade liberalization on manufacturing firms in developing countries, for instance, consistently shows just the opposite: that increases in import penetration as well as reductions in protection are associated with reductions not increases in plant size. Thus, rather than improve efficiency immediately, an important finding of this study is that liberalization may work against the (scale) efficiency of SMEs in the short run (or if there are gains of efficiency, they are quite small).[6]The Tybout's findings are supported by Tewari's (2001) findings from Tamil Nadu's experience in the past fifteen years. After the government removed restrictions on many industries, including textile, allowing anyone to enter the industries, and simultaneously liberalized trade, there was a spate of entry by relatively small firms in the industries, notably textiles. Firms with 400-500 spindles set up shop, in contrast to the 10,000-20,000-spindle plant that larger firms operated. By the mid 1990s, the average plant size in the spinning industry had fallen significantly. Other important studies on the effect of trade reform on SMEs are given in Box 1.

In Indonesia, within many existing studies on SMEs in the country, perhaps the only evidence on the effects of trade reforms before the 1997/98 economic crisis on SMEs' exports is from a field study conducted by Berry and Levy (1994). They surveyed 91 SME exporters in three sub-sectors of manufacturing, and conducted intensive interviews with 30-40 public and non-profit agencies active in SMEs issues between January and June 1992. The three sub-sectors were garment in Jakarta and Bandung (both are in West Java), rattan furniture in Jakarta and Surabaya (East Java), and carved wooden furniture in Jepara (Central Java). From a total of 33 interviewed rattan product exporters, they found that all but one of the firms sampled exported 90% or more of their output, and 26 of 33 firms began exporting the same year they entered into production. Most of them started to export or increased their export share in their total production since the Indonesian government imposed bans on the export of unprocessed and semi-processed rattan in 1986 and 1988-89 respectively. So, it seems that the ban has been a key factor leading to a major expansion in rattan furniture exports of Indonesia's SMEs.[7]Indeed, there are many cases, though unfortunately no official data are available, showing that free exports of raw materials have

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Bonaccorsi (1992) for a survey. The literature associated with export marketing, on the other hand, suggests that LEs have greater resources to gather information on markets in foreign countries and to cover uncertainties of a foreign market (see e.g. Wakelin, 1997). It is, therefore, as a general hypothesis, that LEs, not SMEs, are likely to be more export-oriented.

[5] This is generally supported by the econometric results. .See for example, Aggarwal (2001) and Tybout *et al* (1991).

[6] See further Tybout's review (2000).

[7] Indonesia has long been a major supplier of raw rattan to the major rattan furniture exporting countries of Taiwan and the Philippines. In an effort to 'jump-start' the rattan products industry in the country, the Indonesia government imposed this restriction policy (Berry and Levy, 1994).

created difficulties for SMEs. For example, several times in the 1980s and also in the 1990s SMEs in the three largest metalworking industry clusters in the country, i.e. Tegal and Ceper in Central Java and

Pasuruan in East Java, experienced a serious problem to continue or expand their production due to the lack of local scraps as their main used raw material. This material has been exported mainly to China, leading to scarcity in local market for SMEs. Another case is from PT Panasonic Manufacturing Indonesia, the leading electronic company in Indonesia, which has subcontracting linkages with many SMEs to manufacture a variety of electronic products, including water pumps. For this latter item, recently, its subcontractors facing difficulties due to the lack of brass as one among their main raw materials as this one is also freely exported.[8]

Box 1: Other important studies on the effects of foreign trade reform policy on local SMEs

Valodia and Velia (2004) investigated the relationship between foreign trade liberalization at the macro level and its micro or firm- level adjustment effects in the South African manufacturing industry, and their findings suggest that there is a strong relationship between firm size and international trade. More than half of firms not engaged in international trade are small firms. At the opposite extreme almost half of the firms that are involved in both importing and exporting are large firms employing more than 200 workers. It seems that larger firms have been more successful at integrating their manufacturing activities into global chains of production.

Tewari and Goebel (2002) studied SMEs competitiveness in Tamil Nadu (in Southern India). They find two interesting facts. First, SMEs in some industries are doing better than those in others; just as some industries are doing better than others. Second, SMEs tied to low-end market segments in large urban or metro areas appear to be the most vulnerable to cheap import competition from overseas. Ironically, SMEs serving similar niches in the rural areas or in small towns do not face the same pressures. Their access to intricate, socially embedded distribution networks linking them to rural markets appears to be a source of strength that non-local competitors will find too costly to replicate.

Others such as, Kaplinskly and Readman (2001), Kaplinskly, *et al*. (2002), Roberts and Tybout (1996), and Roberts (2000) suggest that the path to growth for SMEs in a trade liberalized world lies in their ability to compete with imported goods and services, and this depends much on their ability to upgrade their production capacities, access to human resource and new technology, and to improve the quality of their products.

Official data as well as literature show that most of the Indonesian SMEs doing export, do it indirectly via subcontracting systems with LEs in which SMEs manufactured semi-final products and then finalized by LEs (for instance, in food industries, processing raw materials into ready-made foods takes place in SMEs and packaging in LEs). It has been widely accepted that for SMEs to succeed on the export front they must have some way to lower production or to increase efficiency and quality of their products. Berry et al (2001) suggested that subcontracting with either LEs or trading companies is one route. Berry and Levy (1999) reported that in Indonesia subcontracting arrangements were common among SME exporters in rattan, furniture and garments. They argue that the growth of export of SMEs in these manufacturing subsectors no doubt reflects a rapidly increasing importance of subcontracting arragements, mainly with commercial intermediaries. But, no similar evidence can be found in other subsectors such as metal products and electronics industries.

From those who export directly, not all of them do it through shipments to overseas markets, but they sell their products to foreign tourists who visit their villages or workshops. They are called “buyers market”-oriented SMEs. Van Dierman (1997), Knorringa (1998), Cole (1998) and Sandee et al. (2000) find that in certain subsectors, most export-oriented SMIs in clusters operate in buyer-driven commodity chains. Their studies show how SMEs penetrate global markets via buyer-driven trade

[8] Interview with Mr Daniel Suhardiman, Group Manager from PT Panasonic Manufacturing Indonesia.

networks with cases of furniture and garments in Jakarta, garments in Bali, and carved wooden furniture in Jepara (Central Java). These studies also show clearly that foreigners who came to Indonesia as tourists and visited the furniture cluster in Jepara or clusters of garments SMIs in Bali have played an important role in modernizing the production method and quality of products in these clusters and linking them to international markets.

Shortly after the economic crisis in 1997, van Dierman at al. (1998) attempted to assess the impact of foreign trade and investment policy reforms related to the IMF sponsored deregulations under the Letter of Intent (LOI) on SMEs in the manufacturing industry in Indonesia. It shows that the likely impact varies by subsector or group of industry. SMEs in the pre-crisis most protected industries were expected to be adversely affected than those in the less protected ones. However, the assessment has some serious limitations. The most important one is the fact that it was based on secondary data and a survey of literature on SME development in various groups of industry during the crisis period. No field surveys or indepth interviews were conducted. Thus, the increased production costs due to the huge depreciation of the rupiah, not the protection tariffs reduction, could be the reason for the closed down of many SMEs in several industries which was observed during that period.

Other studies on SMEs in Indonesia may indicate, though not explicitly, the important effects of macroeconomic policies versus special designed programs on SMEs, as they conclude that most SME development programs (e.g. subsidized credit, various training programs, external trade promotions, and subcontracting schemes) have not been very successful.[9] They argue that friendly macro economic policies, including trade policies (e.g. import and export regulations) are very important for SMEs growth. For instance, based on his analysis of the effects of macro-and micro-policy environments on rural industries in Indonesia, van Dierman (2004: 53) states that a significant number of macro policies such as trade (protection) policies placed additional costs and burdens on rural SMEs. He argues, therefore, that macro-policies that created a favorable economic environment, as reflected by consistently high growth rates in GDP, and not biased in favor of large enterprises (LEs), provided the best stimulus for SME growth.[10]

Recently there has been a debate which is important for both researchers and policy makers in Indonesia, namely does participation of SMEs in the global economy lead to their sustainable growth? Some contributors to this debate are rather sceptical.[11] Perhaps, the wood furniture industry cluster in Jepara is a good test case, as underlined by a number of papers on this industry.[12] For instance, based on their assessment on whether enterprises and workers in this cluster have gained from producing for the global market and whether the gains are sustainable, they find that the cluster has made gains by participating in export activities; the growth in the number of enterprises and in the number of jobs is undeniable, and the earnings of workers have also increased substantially. However, the industry's