V PROMOTING SME DEVELOPMENT: SOME ISSUES AND SUGGESTIONS FOR POLICY CONSIDERATION

by Thitapha Wattanapruttipaisan[1]

SMEs are of great socio-economic importance

On several social and economic grounds, small and medium-sized enterprises (SMEs) are of overwhelming importance in most Asian countries, those in the Association of Southeast Asian Nations (ASEAN) included.[2] Typically, the SME sector accounts for upwards of 90 per cent of all firms outside the agricultural sector of East and South-East Asia, and of Japan as well. It is also the biggest source of domestic employment, providing a livelihood for over three quarters of the region's workforce, especially women and the young. The relative share of SMEs in total output and exports is generally much smaller, i.e., one third or less. [3] As such, the SME sector will remain the backbone of virtually every economy in this region and, for that matter, of the world in the foreseeable future.

The 1997-1998 crisis has renewed policy focus on SMEs

A concerted push in support of SME growth and competitiveness, moreover, is no longer an option. In fact, the financial and economic crisis of 1997-1998 has induced a return to "the fundamentals" among the "miracle economies" in East and South-East Asia, including a renewed focus on SMEs. This policy shift has been complemented by higher budget allocations and external aid for the SME sector, including sizeable resources made available by Japan under the so-called New Mizayawa Initiative. Such a reorientation is needed not just to underpin the ongoing socio-economic recovery, which was derailed somewhat again by the 2001-2002 global

[1] Senior Officer, Industrial Services Unit, ASEAN Secretariat, Jakarta, Indonesia.

[2] The ASEAN SME Agencies Working Group has been functioning since 1995. The Asia-Pacific Economic Cooperation (APEC) grouping was established in 1989; currently, it has 21 developing and developed economy members. The first APEC SME ministerial meeting was held at Osaka, Japan, in 1994. The APEC Ad Hoc Policy Level Group was first convened at Adelaide, Australia, in the following year and this Group was then converted into a permanent working group in 2000. However, SME issues are also considered by other APEC working groups as they are of a cross-cutting nature, especially in terms of their multisectoral implications and interdependence.

[3] The acute shortage of comparable and up-to-date data on SMEs gives a spotty picture as regards, among many other parameters, their output composition and direct and indirect export production. This chronic shortage is a structural weakness in statistical services common to virtually all developing economies (Hall 2002: 12-17, Regnier 2000: 35-37, and ILO 1977: 36-37). For a more recent and detailed discussion of the important social and economic characteristics of SMEs as well as the impact of 1997-1998 crisis on them, see Alphonso and Co (2001), Regnier (2000), Tambunan (2000), Urata (2000), and van Diermen and others (1997).

economic slowdown. It is also necessary to accommodate an expanding pool of millions of job-seekers (especially young and female workers) and, at the same time, to widen the available opportunities for current as well as potential SME entrepreneurs themselves.

A NEW DEVELOPMENT CONTEXT

Development conditions and circumstances have changed fundamentally

SMEs and, by extension, all business firms have to manage growth and change in an environment where the pace, patterns and organization of production have evolved fundamentally since the late 1980s. Trade liberalization at the global and regional levels and the new information and communications technologies (ICT) have entwined to create rich opportunities as well as formidable challenges to all interdependent countries and enterprises. The following notes on some of the opportunities and challenges most pertinent to SME development serve as a backdrop for the ensuing discussion on related policy issues and suggestions to promote SME growth and competitiveness in the coming decade.

Vast opportunities

There are great opportunities for gainful trade …

A larger proportion of global output is now exported. The ratio of world exports to production was just under one fifth in the late 1990s, compared with only 12 per cent in the early 1980s (ESCAP 2000: 8-9). Even during the global economic slowdown of 2001, the value of world trade (exports) reached US$ 12.7 (US$ 6.2) trillion. Regionally, intra-ASEAN trade has also expanded faster than the group's total trade while the proportion of goods destined for trade within ASEAN is much higher than before the progressive and accelerated tariff reduction arrangements, starting in 1993, under the ASEAN Free Trade Area (AFTA).[4] In addition, most wealth-creating assets such as finance and technologies can now be packaged, located and relocated with relative ease within and across economies and regions.

… for inter-firm linkages to enhance collective capabilities and competitiveness …

Furthermore, there are now greater scope and more opportunities for inter-firm linkages for enhanced collective efficiency, technological and innovation capabilities, and hence competitiveness. In particular, the proliferation of complex networks of international production and cross-border supply chains has widened and deepened the potential and avenues for SME involvement. Furthermore, subcontracting and outsourcing relationships now cover processing and manufacturing activities and services of high value addition and technological sophistication, ranging from original equipment manufacturing, complete-package production, product design and

[4] By comparison, the value for ASEAN trade (exports) was US$ 0.7 (US$ 0.4) trillion during 2001. Annual growth in intra-ASEAN trade averaged almost 12 per cent during 1993-2000; intraregional exports were equivalent to 23 per cent of the total export value in 2000, a much higher proportion than the corresponding figure a decade previously.

engineering, and research and development (R&D) to various other high-end support services.[5]

… and for ICT-based productivity improvements and e-commerce

Another development trend pushed and pulled by the ICT revolution is the significant uplift in productivity, resilience and flexibility of economic activities and services in consequence of the widespread diffusion of ICT.[6] In particular, these new technologies are behind the tremendous upsurge in e-commerce. Currently, this market is largely confined to the developed region, which, for example, accounted for 85 per cent of business-to-business transactions (estimated at some US$ 450 billion) in 2000. E-trade is expected to grow at an exponential rate to reach the trillion-dollar mark well within this decade.[7] Trade via the Internet has now become an intrinsic part of an increasingly large number of SMEs in the developed countries. Respectively about one half and one third of the medium- and small-sized enterprises in Europe maintain an e-mail contact address or a presence on the World Wide Web; there are no comparable data in the case of SMEs in ASEAN or Asia.

Daunting challenges

Formidable challenges to economies and enterprises have also emerged through, for example, more intensified competition …

But the almost unlimited opportunities for gainful growth through trade on the demand side are counterbalanced by formidable challenges on the supply side. First, competition has become increasingly fierce among the global and regional economies and enterprises, SMEs included. There are also many more producers competing for both existing and new markets and market segments for goods, services, finance and other wealth-creating technologies and knowledge. The competitive strength of China was notable in the above regard, even before the country became a member of World Trade Organization in December 2001. Indeed, market penetration and displacing

[5] The process has contributed to a paradigm shift in industrial organization from large-scale vertical integration of hierarchies (of the Fordish and Taylorish varieties) to flatter horizontal production arrangements. These involve the collective participation of smaller enterprises which are, nevertheless, interlinked online and in real time within and across borders. SME participation in the circuit of subcontracting and outsourcing is thus an attractive and feasible bridgehead to durable competitiveness – especially in R&D-intensive sectors, activities and services. See Porter, Sachs and McArthur (2001); Altenburg (2000); Gereffi (1999); and Humphrey (1998). A detailed discussion on the issues, implications and ancillary requirements relating to SMEs as subcontractors on both the supply and demand sides can be found in Wattanapruttipaisan (2002a: 70-84).

[6] Largely as a result, the rate of economic growth in many countries has been boosted higher and their competitive edge has become increasingly sharper. The United States economy, in particular, displayed an astounding performance in the 1990s with an extended period of expansion which became the longest on record in April 2000. Equally striking is that yearly output went up by some 4 per cent during 1997-1999 and by as much as 5 per cent for the first half of 2000. For an examination of some of the major economic benefits of ICT, see APEC (2001: 23-36) and UNCTAD (2001: 25-38).

[7] It should be noted that there are at present very large variations in estimates of the size of e-commerce ranging, for example, from US$ 200 billion to over US$ 600 billion in 2000 alone. Such large discrepancies are due to definitional problems coupled with a critical lack of data and information. See APEC (2001) and UNCTAD (2001) for a comprehensive survey and useful analysis of issues relating respectively to the new economy and e-commerce, the latter with special reference to selected service sectors.

pressures from China have been keenly felt by producers across Asia, particularly those suppliers (including SMEs) at lower stages of technology sophistication and relying on a high import content.[8]

… and more exacting and frequent changes in market standards and demands

Second, consumer preferences and market standards have become more sophisticated and exacting. Competitive advantage is now determined by several non-price parameters such as quality, health and safety, social equity in employment and production, and ecological compatibility of products and processes. Furthermore, market demand is constantly changing, a trend facilitated not least by the rapid advances in ICT, bio-engineering and new materials sciences. In consequence, there are more frequent introductions of new products and processes, faster and more innovative design changes, shorter product cycles and smaller output batches, higher quality and greater mass customization, more just-in-time sourcing and greater punctuality in delivery.

POLICY IMPLICATIONS AND OPTIONS

Competitiveness now depends on, and can be raised by, several factors other than location and natural resource endowments

The new development context requires a change in both perception and practices – in other words, a new or different mindset – in the promotion of SME development. As is apparent from the preceding discussion, competitiveness is increasingly man-made; furthermore, it can be leveraged by factors other than location and natural resource endowments. One lever is through the maintenance of ongoing access to the available store of global information and knowledge, including market standards, marketing opportunities and innovative technologies. Another is embodied in the large gains in collective efficiency and flexibility through participation (whether or not at arm's length) in clusters of firms, or in networks of interlinkages backward with suppliers, laterally with other producers and providers, and forward with users and consumers. Yet another leverage relates to the firm's own capabilities for ongoing learning and improvements in efficiency and flexibility; indeed, business enterprises (both large and small) must become and remain learning organizations under the new development paradigm.

[8] For example, China has managed with notable success to gain a larger share in the G-7 market – namely, Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. Its share in clothing doubled in the 1990s to around 20 per cent, an expansion achieved largely at the expense of exporters from East Asia with the market share of ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand) remaining largely stagnant at around 8 per cent. The G-7 market for footwear is now dominated by China, whose relative share was less than 10 per cent in the late 1980s but grew as high as 38 per cent in the late 1990s. Again, this has taken place at the expense of both the East Asian suppliers and ASEAN-4. Similar trends in market penetration by China can also be observed in sectors such as telecommunications equipment, office and automatic data processing machinery and electrical appliances. Meanwhile, China has been and will remain the dominant supplier of textiles and clothing to Japan, with a relative share rising from 44 to 62 per cent between 1993 and 1999. For further details, see OECD (2002: 138-142). Wattanapruttipaisan (2002b) discusses at some length the gains, issues and implications associated with the proposed ASEAN-China Free Trade Area; this proposal was made at the summit of leaders in Singapore in November 2000.

Competitive SMEs can transform regions and economies

A note of cautious optimism is warranted at this juncture. There is much evidence on the emergence of competitive industries and on the revitalization of domestic regions pushed and driven largely by networks and clusters of SMEs. The process has taken place in both developed countries, notably Western Europe in the late 1980s, and developing economies.[9] Within Asia itself, many large domestic firms as well as transnational business conglomerates, commanding widespread "brand" or "name" recognition, are born and bred locally. However, the very large majority of them had a more humble origin mostly as small-scale enterprises, often operating in smaller townships, at the initial stages of their start-up around half a decade or so ago.[10]

Monitoring and benchmarking competitiveness

Resource constraints emphasize the need for policy focus and targeting …

In general, SMEs will have to be assisted and facilitated to grow, multiply and replicate into a sufficient (critical) mass across industries and sectors. In the process, the level of competitiveness and dynamism of domestic enterprises and, by implication, of the economy as a whole will be greatly enhanced.[11] However, focus and targeting are unavoidable in the context of SME support activities and services. On the one hand, Government has become "leaner and meaner" with functional divestment through policy liberalization, asset privatization and administrative deregulation. In fact, no countries will have the necessary resources for the concurrent and open-ended support of the massive number of their SMEs; these range from several hundred thousands to a few millions in the larger, more populous and/or SME-intensive economies (e.g., China, Indonesia, the Republic of Korea, and Taiwan Province of China).

[9] See, for example, Liedholm and Mead (1998); UNCTAD and GATE (1993); and Senenberger, Loveman and Piore (1990) plus the extensive bibliographies cited in those publications.

[10] Yoshihara (1988: 153-263) provides an interesting and extensive account of the stellar rise of many of the present conglomerates which were formerly small and family-controlled enterprises in South-East Asia. In a related context, two of the world's most famous corporations, Sony and Honda, started out as small manufacturing companies in small-town Japan.

[11] Efficient firms, for example, make it possible for other enterprises to purchase inputs more cheaply. Dynamic and innovative firms induce others to keep up with the latest technologies in production, management and organization. Flexible enterprises speed up the capabilities to respond quickly in other firms which have forward or backward linkages to them. Indeed, the recent attention to national competitiveness and competitiveness studies reflects a growing appreciation that competitive advantage is systemic in nature. There is a large amount of literature on the concept, and policy implications, of "systemic competitiveness". See, for example, Porter, Sachs and McArthur (2001: 17-23); Esser and others (1999: 62-85); and Altenburg, Hillebrand and Meyer-Stamer (1998); and the references cited by them.

… and for an efficiency-oriented, time-bound approach in support and facilitation of SMEs

On the other hand, there are huge differences in the capabilities and competitiveness of SMEs. As is the case of sectors and industries regarded by Government as of priority importance,[12] business enterprises deserve closer attention and concerted support if they are more efficient, innovative, growth-oriented, outward looking, learning-capable and linkage-ready. First, such firms are likely to be very much fewer in number. Policy intervention would have a better chance of success as it would be more focused and manageable, both administratively and financially. Second, they will be more receptive to an efficiency-oriented and time-bound approach in policy support and facilitation. This approach is similar to the provision of fishing rods and related fishing skills to SMEs; it is thus different from the distribution of the fish itself to the target beneficiaries as has often been the case.[13] Third, they are also better placed for self-diagnosis and self-improvement after the initial provision of assistance and facilitation. Meanwhile, partial cost recovery in cash and in kind, plus resource pooling, are comparatively more feasible among these target firms.

Thus, the current and evolving capabilities and competitiveness of selective segments of the SME sector have to be measured, monitored and benchmarked in an objective and systematic manner

Competitiveness has a foundation at the microlevel, whether or not it is measured and benchmarked at the industry, sectoral or national level (Porter, Sachs and McArthur 2001: 21). Regrettably, however, there is currently little, if any, data and information needed for more focused and effective monitoring and comparison of the evolving capabilities and potential of the top layers of SMEs in priority sectors and industries over time. Such an exercise is indispensable for an accurate identification of the core competencies of the SMEs under consideration as well as of their shared areas of weakness for follow-up capacity-building. Indeed, learning what a country and its enterprises are, or can be, good at producing is a key challenge of economic development (Rodrik 2002: 7a). But the same exercise is also essential for better SME performance management and policy impact assessment. In particular, useful benchmarks can be obtained as to the ongoing changes (whether progressive or regressive) in the capabilities and competitiveness of direct SME exporters and first-rank SME suppliers to large domestic enterprises or cross-border production networks. These benchmarks constitute a solid input for the consideration of policy framers as well as for emulation by those SMEs currently in the lower ranks or tiers of suppliers.

To be credible, the data and information for monitoring and benchmarking purposes have to be obtained in an objective, systematic, periodic and

[12] Generally, these priority sectors and industries are likely to exhibit high levels of employment, value added and/or technological sophistication; extensive inter-firm linkages (backward, lateral and forward within and/or across borders); a heavy export orientation; and prospective economies of scale and scope. Typically among those with a large SME presence are a wide range of agro-processing activities (e.g., food, wood and fisheries), manufactures (certain automotive and electronics parts and components, textiles and garments, and some capital goods), pharmaceutical products, information technologies, construction, and hotel and tourism services.

[13] A welfare-based policy approach in support of the SME sector has its own deserved place within the overall policy and institutional framework. It is necessary to safeguard social equity and act as a social safety net in times of crisis or transitional adjustment. But this has to be explicitly stated in terms of objectives and expected outcomes for the needed transparency and accountability, as well as for accurate and measurable performance evaluation.

(statistically) robust manner. The persisting shortage of sample survey results in this regard is another structural statistical weakness in most developing countries, despite the intrinsic socio-economic importance of SMEs and the renewed policy focus on them. In this connection, a framework for such a remedial exercise is discussed at length, and a pilot project for testing purposes proposed, in Wattanapruttipaisan (2002a: 70-78 and 84-85).[14]

Subcontracting compact

Sustainable arrangements in subcontracting and outsourcing depend on sustained compliance with exacting requirements by the SMEs involved

As noted previously, inter-firm networking is a ready bridgehead to domestic and external competitiveness, and the promotion of it has been given high policy priority in the developing world, including ASEAN. The sustainability of such inter-firm arrangements is naturally conditional on durable compliance with exacting requirements for outsourcing and subcontracting (Altenburg 2000, Gereffi 1999 and Humphrey 1998). However, a major drawback in business-matching events and trade fairs is the lack of solid information regarding the evolving capabilities of the producers concerned. A product or service may appear competitive on display but there is no guarantee that the needed volume or variety of supplies can be produced by the pertinent enterprises cost-effectively, and with their quality and reliability remaining uniform or assured. In addition, sustained competitiveness depends on learning-based and innovation-driven improvements in product design, quality and delivery. For a variety of reasons, however, the incremental improvements may not be realized in an efficient, continuous and flexible manner by the suppliers concerned.

The compliance process requires changes in both perceptions and business practices by many SMEs

Indeed, the compliance process itself requires mindset changes because a large number of subcontracting prerequisites are traditionally not practised or expected by most SMEs, among other firms. To begin with, there is little room for compromise with quality, and compliance with quality management systems recognized worldwide is through certification under the International Organization for Standardization (ISO) 9000 series of standards, ISO 9001 and 9002 especially.[15] Such certification is no longer an option. But changes

[14] Briefly speaking, SME capabilities and competitiveness are conceptually grouped under seven categories, each with its own set of parameters and guidelines. The overall environment in which SMEs operate is categorized as "Nature and readiness of firms". "Entrepreneurial characteristics" are the driving force of enterprises, whether they are large businesses or SMEs. The two categories dealing with "Capabilities" and "Competitiveness" are indicative, by and large, of the initial conditions and circumstances of the SMEs concerned. Matters included in "Production organization" serve as a proxy for the potential for productivity upgrading and competitive growth by the SMEs under consideration, a process which is innovation-led, learning-based and investment-driven. In a way, this category mirrors the (new) Growth Competitiveness Index, which was (recently) introduced in 2000 by the World Economic Forum (WEF). Meanwhile, the groupings on "Capabilities" and "Competitiveness" are an approximation of the WEF Current Competitiveness Index. The last two categories are "Finance" and "Human resource development".

[15] The two are identical except for the exclusion of the design element from ISO 9002. ISO 9001, for example, covers 20 separate system elements pertaining to design, development, production, installation and servicing. Moreover, certain system elements relating to environmental safety and control have recently been incorporated as part of the revised version of ISO 9001. This is because the ISO 14000 series of standards are not directly concerned with manufacturing processes.

are also required in several other business practices, which include certain conditions as to employment and workers' amenities in the workplace, regular audits of factory layouts and work flows, the offer of unconditional product warranties and after-sales service, and the extension of credit on delivered products. There is, moreover, the imposition of penalties for under-performance, for example, in terms of quality consistency, defect and rework ratios and liabilities, and timeliness in delivery (Altenburg 2000: 32-34).

A subcontracting compact or subcontracting code of conduct for SMEs?

All these require, in turn, a compilation of the typical preconditions for inter-firm networking, including through subcontracting. The listed specifications can be regarded as general guidelines or "best practices" for emulation expected of SMEs from the demand side. Likewise, from a supply-side perspective, they can form the basis of an SME subcontracting compact or "code of conduct". Demonstrated adherence to such a compact or code would qualify the SMEs concerned as ready for participation in subcontracting or outsourcing arrangements, just as ISO certification does for quality control, assurance and management.

ICT and e-commerce

Parallel efforts at demand-side market creation and supply-side capacity-building are required for the more effective and widespread diffusion and adoption of ICT and e-business, including within the SME sector

The issue in this context is not whether to assist SMEs in investing in ICT-based facilities and services. Rather, it is how best to encourage SMEs to make the most cost-effective use of the new technologies in production, marketing and networking. A word of caution is necessary, however. First, the tremendous expansion in digital connectivity and e-commerce has been highly concentrated in North America and Western Europe, as pointed out earlier. Second, many regional SMEs, those on the top layers in priority industries and sectors especially, will surely have "to go with the flow" of electronic interactivity (or be crushed by it). As surely, however, there is an extensive agenda to be accomplished before large segments of the SME sector can be transformed into the so-called "virtual" enterprises and entrepreneurs.

Within the middle- and low-income countries in Asia, for example, the constraints on e-commerce among SMEs are wide-ranging.[16] Significant efforts have to be made by both the public and private sectors to create,

[16] There is the Catch-22 issue of low and limited usage of e-business by both customers and suppliers at present. This reflects, in part, a lack of trust and confidence, which itself is due to an inadequate supply of soft infrastructure (as regards, for example, the security of transactions; appropriate support, payment and distribution systems; e-contract enforcement; and other legal and liability issues both within and across borders). There are also limited knowledge, awareness and skills on the part of SMEs concerning the promise and requirements of ICT as well as e-business. Moreover, significant barriers exist in the form of insufficient access of SMEs to ICT infrastructure, hardware and software of suitable quality and at an affordable cost in time and money. PricewaterhouseCoopers (1999) contains a useful survey of the main issues and options relating to e-commerce and SMEs in the APEC region. Debroy (2001: 37-43) provides a sober view on "www" in the Indian context, namely, where will the ICT diffusion happen (urban and/or rural areas?); who will facilitate it (private initiatives or government?); and lastly, there is the why for the education system itself. A detailed consideration of e-commerce in the context of low-income countries and economies in transition, specifically China, can be found in UNCTAD (2001: 189-250).

regulate, stabilize and legitimize the domestic markets for both ICT and e-business. This process is wide-ranging in its intersectoral implications, involving property right protection and contract enforcement, awareness-raising and information dissemination, the provision of time-bound incentives and other assistance, etc. At the same time, parallel measures will have to be carried out to build up the ICT and e-commerce capabilities and potential of the targeted SMEs, thus enhancing productivity and competitiveness on the supply side. An overarching issue in connection with market creation and capacity-building is the quality, relevance and accessibility of domestic institutions for education, training and extension services to underpin more effective diffusion and adaptation of ICT economy-wide over time.

Policy consistency

There is scope for greater consistency and better coordination of policies and regulations …

An enabling policy and institutional environment matters even more in another context. Because of their limited scale of operations, the costs of participation and capacity-building are relatively more disproportionate for SMEs, compared with those shouldered by large firms. At the same time, by default or by accident, changes and adjustments in the policy, regulatory and institutional framework have not always empowered SMEs. The sector and its entrepreneurs are often constrained by opaque discretion, overbearing regulations, expensive delays and, above all, the well-known "perverse incentive syndrome".[17] Remedial efforts have been made by countries to promote SMEs, including through the provision of both inducements and prerequisites for large-scale and transnational enterprises to foster backwards and forwards linkages with smaller-scale suppliers. But again, this "carrot-and-stick" approach remains feasible and sustainable only with the continuous availability of SME inputs which comply with the exacting requirements of subcontracting and outsourcing.

… and a one-stop institution in support of SME sector growth, transformation and integration

A one-stop agency for the promotion of SME development would prove helpful, just like its counterpart in the promotion of foreign direct investment. There has been some centralization of responsibilities in a number of countries, including Malaysia and Thailand, where the main concern is to ensure better coordination and greater coherence and consistency of policies and regulations impinging on SMEs. However, other important functions include advocacy, outreach (especially in capacity-building and information dissemination) and policy performance and impact evaluation. Again, an effective discharge of these functions would depend significantly on the systematic and sustained collection of data and information for the monitoring and benchmarking of SME capabilities, competitiveness and adherence to certain subcontracting compacts or codes of conduct, as discussed earlier.

[17] This originates from the minimum requirements in production scale, local content, capital investment and/or export levels as a precondition for government incentives and assistance. There are valid economic, financial and technological reasons for granting benefits and privileges in exchange for certain minimum or baseline conditions or stipulations (e.g., prospective economies of scale and scope, greater employment volume and market penetration, easier transfer and dissemination of new technologies, and better intellectual property and environmental protection).

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